● OFFICIAL TRANSCRIPT OF PROCEEDINGS
BEFORE THE
POSTAL RATE COMMISSION

In the Matter of:)

)   Docket NO.: R2006-1

POSTAL RATE AND FEE CHANGES   )

POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

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POSTAL RATE COMMISSION

In the Matter of:)
)   Docket No.: R2006-1
POSTAL RATE AND FEE CHANGES   )

                              Suite *200*
                              Postal Rate Commission
                              901 New York Avenue, N.W.
                              Washington, D.C.

                              Volume **24**
                              Monday, October **30, 2006**

        The above-entitled matter came on **for** hearing

pursuant to notice, at **9:36** a.m.

BEFORE:

        HON. GEORGE A. **OMAS,** CHAIRMAN
        HON. DAWN A. TISDALE, VICE-CHAIRMAN
        HON. RUTH Y. GOLDWAY, COMMISSIONER
        HON. TONY HAMMOND, COMMISSIONER
        HON. MARK ACTON, COMMISSIONER

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C O N T E N T S

WITNESSES APPEARING:
    JANYCE PRITCHARD (Did Not Appear)
    ANITA PURSLEY (Did Not Appear)
    ROBERT POSCH (Did Not Appear)
    AARON HOROWITZ (Did Not Appear)
    ALLAN T. INGRAHAM
    HARRY KELEJIAN

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C O N T E N T S

E X H I B I T S

EXHIBITS AND/OR TESTIMONY	IDENTIFIED	RECEIVED
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Corrected designated written cross-examination of Janyce Pritchard, PostCom-T-1	8643	8643
Corrected direct testimony of Anita Pursley on behalf of Association for Postal Commerce, PostCom-T-2	8653	8653
Corrected designated written cross-examination of Anita Pursley, PostCom-T-2	8654	8654
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Corrected direct testimony of Aaron Horowitz on behalf of Association for Postal Commerce, PostCom-T-6	8682	8682
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Corrected direct testimony of Allan T. Ingraham on behalf of Newspaper Association of America, **NNA-T-2**	8713	8714
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EXHIBITS

EXHIBITS AND/OR TESTIMONY	IDENTIFIED	RECEIVED
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Corrected designated written cross-examination of Harry Kelejian, GCA-T-5	8742	8742

1   P R O C E E D I N G S

2   (9:36 a.m.)

3   CHAIRMAN OMAS: Good aorning. Today, we

4   continue hearings to receive the direct case of

5   participants other than the Postal Service in Docket

6   No. R2006-1, Considering the Postal Service's Request

7   for Rate and Fee Changes.

8   I have one procedural matter, at this point,

9   this morning. I have today issued a ruling on the

10   Greeting Card Association motion for expedited relief.

11   A temporary protective order has been granted. Copies

12   of the ruling will be made available in the hearing

13   room today.

14   Before we proceed, does anyone have any

15   procedural matters to discuss, at this point, this

16   morning?

17   (No response.)

18   CHAIRMAN OMAS: Six witnesses are scheduled

19   to appear today. They are Witnesses Pritchard,

20   Pursley, Posch, Horowitz, Ingraham, and Kelejian.

21   There will be no cross-examination for our

22   first four witnesses: Pritchard, Pursley, Posch, and

23   Horowitz.

24   Ms. Dreifuss, would you please assist us to

25   receive the corrected version of Mr. Pritchard's

1   testimony into evidence, please?

2   MS. DREIFUSS: I would be happy to, Mr.

3   Chairman. I'm Shelley Dreifuss for the Office of the

4   Consumer Advocate.

5   I have in front of me two copies of

6   testimony. It is captioned "Direct Testimony of

7   Janyce Pritchard, FLUTE-T-1," on Behalf of the FLUTE

8   Network. I've been in communication with Ms.

9   Pritchard by e-mail. I think she filed online a

10   declaration for this testimony and for her

11   interrogatory responses.

12   I printed the declaration that she filed

13   online for the testimony, and I put it behind each

14   copy of this testimony. I understand from her that

15   she put an original signed declaration for the

16   testimony into priority mail, but it hasn't been

17   received yet. I imagine it will be shortly.

18   So, Mr. Chairman, I move that these copies

19   of the "Direct Testimony of Janyce Pritchard" be

20   accepted into evidence.

21   CHAIRMAN OMAS: Is there any objection?

22   (No response.)

23   CHAIRMAN OMAS: Hearing none, please provide

24   the reporter two copies of the corrected direct

25   testimony of Ms. Pritchard. That testimony is

1 received into evidence. However, as is our practice,

2 it will not be transcribed.

3   (The document referred to was

4   marked for identification as

5   Exhibit No. FLUTE-T-1 and was

6   received in evidence.)

7   CHAIRMAN **OMAS:** Ms. Dreifuss, have the

8 answers to the designated written cross-examination

9 been reviewed and corrected?

10   MS. DREIFUSS: Yes. To the best of my

11 knowledge, no revisions were necessary to these

12 answers. I've gone through the designation packet,

13 and it looks like I've got two copies here of those

14 interrogatory responses that were designated by the

15 Postal Service. So I ask that these interrogatory

16 responses be entered into evidence.

17   CHAIRMAN OMAS: There being no objection,

18 Ms. Dreifuss, would you please provide two copies of

19 the corrected designated written cross-examination of

20 Witness Pritchard to the reporter? That material is

21 received into evidence and is to be transcribed into

22 the record.

23 //

24 //

25 //

1   (The document referred to was

2   previously identified as

3   Exhibit No. FLUTE-T-1 and was

4   received in evidence.)

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2006   Docket No. **R2006-1**

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF THE FLUTE NETWORK
WITNESS JANYCE PRITCHARD
(Flute-T-1)

<u>Party</u>   <u>Interrogatories</u>

United States Postal Service   USPS/Flute-T1-2-4

Respectfully submitted,

[signature]

Steven **W**. Williams
Secretary

INTERROGATORY RESPONSES OF
THE FLUTE NETWORK
WITNESS JANYCE PRITCHARD (T-1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory   Designating Parties

USPS/Flute-T1-2   USPS
USPS/Flute-T1-3   USPS
USPS/Flute-T1-4   USPS

RESPONSE OF FLUTE NETWORK WITNESS PRITCHARD
TO INTERROGATORIES USPS/Flute-T1-1-4

USPS/Flute-T1-2. For the survey you conducted regarding the February 2006 and March 2006 issues, as you describe the survey on page 31 **of** your testimony, you requested approximately 6,200 subscribers to The Flute Network to respond. and you received 228 responses to your February 2006 request, and 307 responses lo your March 2006 request.

Please confirm that the responses you received were based on the readers' individual decisions to respond to the survey, and not a random selection determined by you. **If** you do not confirm, please explain.

RESPONSE TO USPS/Flute-T1-2. Totally confirmed. To be clear, our request for help with the information we were looking for was printed on the front page of each of the February and March issues - thus all subscribers, everywhere, without restriction, were invited to participate, **All** February and March issues were printed exactly the same for their respective press runs (full copies of both issues are included here, as per the first question of these Interrogatories). Those who responded did *so* freely by their own choice, at their own expense, and without expectation ofremuncration of any son. When all the responses were tallied, we had specific information about 228 of the February issues and **307** of the March issues, nationwide

RESPONSE OF FLUTE NETWORK WITNESS PRITCHARD
TO INTERROGATORIES USPS/Flute-T1-1-4

USPS/Flute-T1-3. Please refer to page 8 of your testimony. where you describe how issues of the Flute Network are prepared. You say. at line 10, that the issues are "folded in half again and tabbed."

(a) Do you mean that each mailpiece measures 8 ½ by 5 ½ inches (because the 8 ½ by 11 inch pages are folded over)? If your answer is no, please indicate the measurements of each mailpiece.

(b) When you say that the issues are "tabbed' do you mean that the mailpiece is fastened on the end opposite to the last fold? If your answer is yes, please describe how the issues are tabbed or fastened. If your answer is no, please explain what yo mean by "tabbed."

RESPONSE TO USPS/Flute-T1-3.

(a) Yes – mailpieces measured no more than 8 ½ by 5 ½ inches; the actual measure was generally 1/16 inch less than that on each dimension.

(b) Yes. The tab consisted of a piece of white paper tape measuring 9116 inch wide by approx. 15/16 inch long. The tab was applied by hand. flush to the edge, on the end opposite to the last fold, with the longer length of the tape bridging the sides being secured.

May I add that in 2002 and 2003, I took samples of our mailpieces with me to two open meetings of our local Postal Customer Council here in San Bernardino, **CA** where the topic of mailpiece design was featured and the program included persons to advise us on such things (I understood these to be "higher ups" in the bulk mail service, and that they had been brought in as "special presenters" from the San Diego USPS offices). Both times, I stayed to the very end and asked specifically for feedback and advice on our mailpiece – both times I was told we were fine as it was. Nothing has changed with ours, then, since that time.
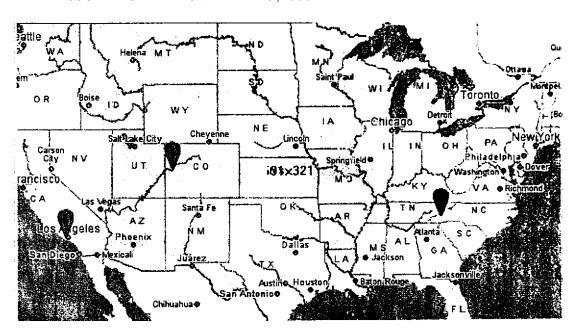
RESPONSE OF FLUTE NETWORK WITNESS PRITCHARD
TO INTERROGATORIES USPS/Flute-T1-13

USPS/Flute-T1-4. Have you collected any other raw data on delivery times for The Flute Network beyond the data presented at page 29 of jour testimony, and the surveys stemming from the February 2006 and March 2006 issues? If your answer is yes, please provide copies of all raw data you collected.

RESPONSE – Yes. (And thank you for this question!)
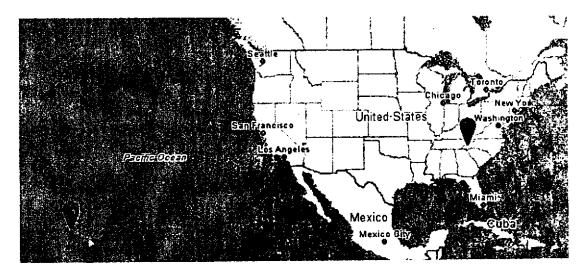
1) Although not specifically asked for, we did hear from four of our subscribers regarding their zip codes and the date they received their April 2006 issues. As before, this information was provided to us out of the goodness of the senders' hearts, totally voluntarily, this time – however - without having been asked for it. Our April issue entered the USPS bulk mail system in Waynesville, NC on April 13,2006. **This** additional raw data is as follows:

APRIL ISSUE RECEIVED ON APRIL 25,2006
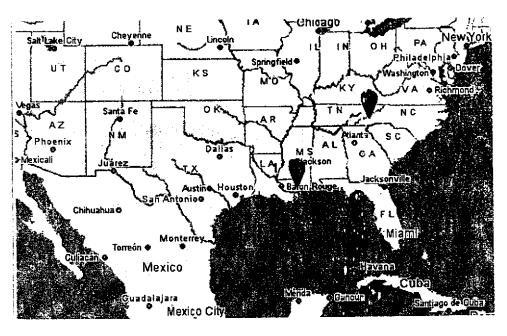
The red pin represents Waynesville, NC – the origination mailing office. The two subscribers reporting receipt of the April issue (mailed **April** 13) on April 25 (i.e., 12 days in transit) are: Clifton, CO at 81520, and Santa Monica, CA at 90403.

APRIL ISSUE RECEIVED APRIL **28**

The red pin represents Waynesville. NC – the originating mailing office. The blue pin represents Kapaa, HI at **96746,** who reported receiving his April issue on April 28th – 15 days in transit.

APRIL **ISSUE** RECEIVED MAY **3**

The red **pin** represents Waynesville, NC – originating mailing office; the blue pin represents 70461 - Slidell, **LA** – who received his **issue** on May **3** (**20** day transit time)

To be clear: all information specifically pertaining to receipt of our February and March 2006 issues is included in the Testimony already provided, without exception.

[Maps included here, again, courtesy of www.frappr.com]

2) On September 13, 2006, we received a follow up communication from the publisher whose experience was included as "k" in Line 20 on page 40 of our Testimony – she had subsequently found some of her notes and provided the following particulars to her experience (to protect the privacy of the individual she named, I will not include it here at this time – it can be provided, however, if deemed necessary). She wrote as follows:

"I did not find the letter I sent to the post office about my complaint, but I found a few notes. _____ in Manchester NH was the one who told me what I should do. He said to send them a form #3533 with a copy of **my** catalog, saying I was a small business. This is what I did. I also sent it with the postage statement from the company who did my mailing with the amount of the postage bill, telling them I had lost a lot of business since the bulk mailing took 5 weeks instead of the suggested 10 days. This has happened 3 years in a row. The mailing was sent April 4, 2005 and took until May 9th for some people to get the catalog. It cost me $1 181.89 in postage. I asked for some compensation on my bill, but never even got an answer."

3. Since filing our Testimony, we also heard from (and took notes about) two other entities who wanted to share with us about their experiences and frustrations with USPS services. Their comments were as follows:

(a) First up, we heard from a large nationwide non-profit organization who also has had longstanding delivery problems with their print publication via USPS Standard Mails (especially of concern to them were the substantial number of complaints received by their office regarding members "pre-convention issue" being received several weeks after

the convention had happened each summer over the past 4 or 5 years, when it had indeed been mailed out well ahead of convention time).

(b) Also heard from is a small manufacturing company located in a suburb in the northwest who spoke to us of numerous problems with USPS services (most notably, the lack of USPS delivery of packages to them which were correctly addressed and unremarkable in terms of size, weight, or frequency – instead, they were/are given only a notice of it/their being available for pick up; the local delivery person was highly praised however – and this company reports understanding that this practice **of** "no knock being necessary/just leave a package notice" was something of a local managerial decision). Of relevance to the topic at hand though was his subsequent comment: "...it all just makes me wonder what else somebody along the way might decide is not wonhy of actual delivery". The promised letter of follow-up to **our** conversation, including more particulars about this company's experience and concerns, has not yet arrived.

1   CHAIRMAN OMAS: Is there any additional

2 cross-examination for Witness Pritchard?

3   (No response.)

4   CHAIRMAN OMAS: There being none, that

5 brings us to Mr. Brickman.

6   MS. BRICKMAN: No. Rita Brickman.

7   CHAIRMAN OMAS: I'm sorry, Ms. Brickman.

8 Ms. Brickman, would you please proceed?

9   MS. BRICKMAN: Yes. Good morning, Mr.

10 Chairman and Commissioners. Witness Pursley was

11 scheduled to appear this morning, but Postal Service

12 counsel notified me that they would have no questions

13 for Ms. Pursley, so PostCom filed notice last week

14 that Ms. Pursley would not be traveling in from out of

15 town for the meeting.

16   So I have brought here with me today two

17 copies of her testimony and her written declaration, a

18 fax copy, and the witness has no corrections to her

19 testimony at this time. At this time, then, I move

20 that the direct testimony of Ms. Pursley be admitted

21 into the record.

22   CHAIRMAN OMAS   Is there any objection?

23   (No response.

24   CHAIRMAN OMAS: Hearing none, Ms. Brickman,

25 would you please provide the reporter with two copies

1   of the corrected direct testimony of Anita Pursley?

2   That testimony is received into evidence. However, as

3   is our practice, it will not be transcribed

4   (The document referred to was

5   marked for identification as

6   Exhibit No. PostCom-T-2 and

7   was received in evidence.)

8   CHAIRMAN OMAS: **Ms**. Brickman, have the

9   answers to the designated written cross-examination

10   been reviewed and corrected?

11   MS. BRICKMAN: I have reviewed the answers

12   to the designated written cross for **Ms**. Pursley, and

13   there are no corrections at this time.

14   I do have a declaration, prepared in

15   advance, that is now attached to this set of

16   interrogatory responses that were compiled by the

17   secretary.

18   CHAIRMAN **OMAS:** Without objection, would you

19   please provide two copies of the corrected direct

20   written cross-examination of Witness Pursley to the

21   reporter? That material is received into evidence,

22   and it will be transcribed into the record.

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1   (The document referred to,

2   previously identified as

3   Exhibit No. PostCom-T-2 and

4   was received in evidence.)

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes. 2006   Docket No. R2006-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF ASSOCIATION FOR POSTAL COMMERCE
WITNESS ANITA PURSLEY
(PostCom-T-2)

<u>Party</u>   <u>Interroaatories</u>

Postal Rate Commission   USPS/PostCom-T2-1, **4**

United States Postal Service   USPS/PostCom-T2-1-6

Respectfully submitted.

Steven **W.** Williams
Secretary

INTERROGATORY RESPONSES OF
ASSOCIATION FOR POSTAL COMMERCE
WITNESS ANITA PURSLEY (T-2)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designating Parties
USPS/PostCom-T2-1	PRC. USPS
USPS/PostCom-T2-2	USPS
USPS/PostCom-T2-3	USPS
USPS/PostCom-T2-4	PRC, USPS
USPS/PostCom-T2-5	USPS
USPS/PostCom-T2-6	USPS

RESPONSES OF POSTCOM WITNESS PURSLEY TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T2-1. Please refer to page 7 of your testimony where you discuss your proposal to increase the passthrough for the 5-digit automation flats presort discount to 100%. Please also refer to the Postal Service's proposed percentage increases for Standard Mail Regular shown in witness Kiefer's revised workbook WP-STDREG-R0621.XLS (USPS-LR-L-36), in the worksheets entitled Financial Summary and Percent Rate Changes.

    (a)   Is it your understanding that the Postal Service has proposed an increase for 5-digit automation flats that is lower than the subclass average?

    (b)   Is it your understanding that the Postal Service has proposed an increase for 3-digit automation flats that is higher than the subclass average?

    (c)   Is it your understanding that, all else equal (including holding total revenue generated constant), a higher passthrough of the cost differential between 3-digit and 5-digit automation flats would lead to an even higher increase for 3-digit flats than that proposed by the Postal Service?

RESPONSE:

(a -b) The average rate increase in Standard Mail Regular is 9.6%, and that the

overall average Postal Service increase is 8.5%, so the Postal Service has

proposed (a) an increase for 5-digit automation flats that is lower than the

subclass average and higher than the overall average increase, and (b) an

increase for 3-digit automation flats that is higher than the subclass average.

(c)   Assuming that is the case, it would provide a very strong incentive for co-

mailing.

RESPONSES OF POSTCOM WITNESS PURSLEY TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T2-2. Please refer to your testimony at page 2, lines **19** to 21
where you claim that destination entry discounts must keep pace with increases
in mailer costs.

a. Please confirm that destination entry discounts must be based on avoidance
of costs incurred by the Postal Service. Please provide a full explanation of any
failure to confirm.

b. Please explain why, if the costs of mailers performing worksharing activities
have risen faster than the costs of the Postal Service performing such activities,
the Postal Service should increase the incentive for mailers to perform the work,
rather than performing the tasks itself, as the low cost provider?

RESPONSE:

a. Not confirmed. Historically, the Postal Service has proposed, and the Postal

Rate Commission has authorized, destination entry discounts based on

avoidance of costs incurred. However, this need not necessarily be the only

factors that must or should influence the setting of these discounts

b. I dispute the premise of this question, because I do not believe that the Postal

Service is the low cost provider of transportation services. That said, the

operational and rate eligibility decisions that the Postal Service independently

makes can and do influence mailers' and mail service providers' costs of

performing worksharing activities such as presortation and drop entry.

Therefore, in recommending the worksharing discounts, I believe the

Commission should consider the extent to which the Postal Service's operational

decisions effectively raise its workshare partners' costs.

RESPONSES OF POSTCOM WITNESS PURSLEY TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T2-3. Please refer to your testimony at page 3 where, at line 8 you identify the proposed passthroughs of 87 percent, 85 percent and 85 percent, and at line 18 where you note that the passthroughs recommended by the PRC in Docket No. R2000-1 ranged from 82 percent to 84 percent. Please also refer to line 20 where you note that in Docket No. R2001-1, the Postal Service proposed passthroughs of 85 percent. Please confirm that the passthroughs proposed in this docket of 87 percent, 85 percent and 85 percent are consistent with or higher than those proposed or recommended in Docket Nos. R2000-1, R2001-1, and R2005-1.

RESPONSE:

Confirmed. However, I also observe that the discounts that were recommended

as a result of the R2001-1 and R2005-1 cases were the result of settlements in

these cases.

RESPONSES OF POSTCOM WITNESS PURSLEY TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T2-4. Please refer to your testimony at page 5, lines 7
through 10, where you state that a mailer's decision to drop ship is based on
whether the mail is palletized and whether the cost of drop shipping exceeds
postage savings.

a. Please confirm that, according to Table 8 of Appendix C of USPS-LR-L-88,
more than half of Standard Mail in sacks is entered at a destination facility.

b. Please confirm that a mailer's decision to transport mail on pallets may depend
on the following considerations:

　　　i. the volume of mail destinating to one geographic area;

　　　ii. the production process in the mailer's/printer's plant

c. Please confirm that if the cost of drop shipping exceeds the postage savings. it
would be inefficient for the mailer to continue dropshipping.

d. If your response *to* part (c) *is* affirmative, please confirm that under such
circumstances, mailers may continue to dropship for service performance
reasons.

RESPONSE:

a.　　　Not confirmed. According to Table 8 of Appendix C of USPS-LR-L-88.

labeled "Breakout of Base Year Standard Mail Pounds by Container Type and By

Facility", 48.7% of sacked mail pounds is drop shipped.

b.　　　Confirmed, although other considerations also enter into the mailers'

decision (e.g., freight cost).

(c – d) I can confirm that there are circumstances where if the cost of drop

shipping exceeds the postage savings, the mailer may continue to dropship for

service performance reasons. I cannot confirm that such a decision would

necessarily be inefficient.

RESPONSES OF POSTCOM WITNESS PURSLEY TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T2-5. Please refer to your testimony at pages 5-6, where you

state that your proposed passthroughs will increase the differential between

DBMC and DSCF entry rates to provide incentive for mailers to bring mail closer

to the ultimate destination.

a. Please confirm that, according to Table 8 of Appendix C of USPS-LR-L-88. 50
percent of Standard Mail on pallets is already entered at the DSCF, and 8
percent of Standard Mail on pallets is entered at the DDU.

b. Please confirm that the same table shows that 29 percent of Standard Mail in
sacks *is* already entered at the DSCF, and **19** percent of Standard Mail in sacks
is entered at the DDU.

c. Please identify the source of the mail that will shitt from origin entry to
destination entry as a result of the incentives your proposed rate design would
offer.

RESPONSE:

a.   Not confirmed. According to Table 8 of Appendix C of USPS-LR-L-88.

labeled "Breakout of Base Year Standard Mail Pounds by Container Type and By

Facility", 54.8% of Standard Mail pounds on pallets is entered at the DSCF and

9.8% of Standard Mail pounds on pallets is entered at the DDU

b.   Not confirmed. According to Table 8 of Appandix C of USPS-LR-L-88,

labelled "Breakout of Base Year Standard Mail Pounds by Container Type and

By Facility", 27.3% of Standard Mail pounds in sacks is entered at the DSCF and

18.0% of Standard Mail pounds in sacks is entered at the DDU

RESPONSES OF POSTCOM WITNESS PURSLEY TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

c.   The same table shows mail that is being entered at the originating

facilities. With a greater discount, some of this mail will be entered at a

destinating facility. Due to rising transportation costs (e.g. fuel prices and USPS

operational changes), deeper drop entry discounts would ensure that mail

currently being drop entered does not revert back to origin entry.

Also, qualifying pallets may become cost effective to enter closer to destination.

For example, SCF pallets currently drop entered at a BMC may shift to SCF

entry.

RESPONSES OF POSTCOM WITNESS PURSLEY TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T2-6. Please refer to page 8 of your testimony at lines 3
through 8.

a. Please confirm that any particular mailing **job** for a Periodicals publication will
have a fixed, or nearly fixed, number of pieces destinating to any given 5-Digit
ZIP Code. If not confirmed, please explain.

b. Please confirm that the ability to create a pallet of mail to any given 5-Digit ZIP
Code destination will depend on the number of pieces destinating within that ZIP
Code. If not confirmed, please explain.

c. Please confirm that efficient use of the floor space on a given truck
transporting mail to a given destination will be based on the number of pallets
that can fit on the truck, and the volume of mail on each pallet. If not confirmed,
please explain.

d. In light of your responses to parts (a) through **(c),** please explain how deeper
destination entry discounts can:

> i. Affect any **of** the responses *to* (a) through (c); and

> ii. Increase the number of pieces entered for any given 5-Digit ZIP Code.

RESPONSE:

a.   My testimony applies to Standard Mail. However, an individual mailing

has a set number of pieces going to a specific ZIP code. In an effort to achieve

more pieces to a specific ZIP code, the mailing can be co-mailed or co-palletized.

b.   Not confirmed. The ability to create a pallet depends on

weight, not pieces. Mailers are required to have a minimum of 250 pounds to

create a pallet based on DMM rules (100 pounds if drop entered). Co-mailing or

co-palletizing will facilitate more weight to a 5 digit ZIP code. Also, combining

RESPONSES OF POSTCOM WITNESS PURSLEY TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

ZIP codes allows preparation of different pallet levels (e.g. 3 digit or SCF) that can also be drop entered.

c.   Not confirmed. Commonly, mail service providers and consolidators combine multiple titles and different classes of mail to multiple USPS destinations per truck. Floor space utilization (known as "cube utilization" in the transportation industry) is merely one component of the optimization process.

d.   Deeper drop ship discounts will drive behavioral change. An individual mailing, with a fixed number of pieces, may not have enough weight to produce a pallet *to* a given ZIP code (or 3 digit or SCF) and may not be drop shipped as a result. In order to gain postage savings (and improved delivery service), the mailer can elect to co-mail or co-palletize to move their pieces from sacks to pallets and enjoy the benefits of drop shipping.

Deeper drop entry discounts will also enhance the cost benefit analysis and increase the amount of mail that is drop entered and palletized. Mailing jobs and destinations that are not cost effective under the current rate structure, can become cost effective with greater discounts. Combining mail (through co-mailing or co-palletization) to increase the weight to a given ZIP code (or multiple ZIP codes) increases the amount of mail that is palletized and also creates heavier, more efficient pallets which enhances cube utilization.

POSTAL RATE COMMISSION
DOCKET NO. R2006-1
DECLARATION OF ANITA PURSLEY

I hereby declare, under penalty of perjury, that:

I prepared the interrogatory responses, which were filed under my **name** and which have been designated for inclusion in the record **in this** docket; and

If I were to respond to these interrogatories **orally** today, the responses would be the same.

_____
ANITA PURSLEY

DATE ___10/27/06___

1   CHAIRMAN OMAS: Is there any additional

2 cross-examination for Witness Pursley?

3   (No response.)

4   CHAIRMAN OMAS: There being none, Ms.

5 Brickman, you may proceed with your next witness.

6   MS. BRICKMAN: Thank you, Mr. Chairman.

7 Witness Posch was the next witness scheduled for this

8 morning, and I was similarly notified that there was

9 no cross-examination by the Postal Service for Mr.

10 Posch, and we provided notice that Mr. Posch would not

11 be appearing this morning.

12   I do have, today, here with me, two copies

13 of his testimony, and the witness has no corrections

14 to his testimony at this time. PostCom, we expect,

15 will file Mr. Posch's declaration shortly after

16 today's hearing. But at this time, I do move that the

17 direct testimony of Mr. Posch be admitted into the

18 record.

19   CHAIRMAN OMAS: Is there any objection?

20   (No response.)

21   CHAIRMAN OMAS: There being none, Ms.

22 Brickman, would you please provide the reporter with

23 two copies of the corrected direct testimony of

24 Richard Posch? That testimony is received into

25 evidence. However, as is our practice, it will not be

1   transcribed.

2   (The document referred to was

3   marked for identification as

4   Exhibit No. PostCom-T-3 and

5   was received in evidence.)

6   CHAIRMAN OMAS: Ms. Brickman, have the

7   answers to the designated written cross-examination

8   been reviewed and corrected?

9   MS. BRICKMAN: Yes. There are no

10   corrections at this time, and I move that these

11   responses be admitted into the record.

12   CHAIRMAN OMAS: Without objection, Ms.

13   Brickman. Would you please prcvide two copies of the

14   corrected designated written cross-examination of

15   Witness Posch to the reporter? That material is

16   received into evidence and it is to be transcribed

17   into the record.

18   (The document referred to,

19   previously identified as

20   Exhibit No. PostCom-T-3 and

21   was received in evidence.)

22   //

23   //

24   //

25   //

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON. DC 20268-0001

Postal Rate and Fee Changes, 2006

Docket No. R2006-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF ASSOCIATION FOR POSTAL COMMERCE
WITNESS ROBERT POSCH
(PostCom-T-3)

Interroaatories

Postal Rate Commission

USPS/PostCom-T3-2, 6

United States Postal Service

USPS/PostCom-T3-1-9

Respectfully submitted,

Steven W. Williams
Secretary

INTERROGATORY RESPONSES OF
ASSOCIATION FOR POSTAL COMMERCE
WITNESS ROBERT POSCH (T-3)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designating Parties
USPS/PostCom-T3-1	USPS
USPS/PostCom-T3-2	PRC. USPS
USPS/PostCom-T3-3	USPS
USPS/PostCom-T3-4	USPS
USPS/PostCom-T3-5	USPS
USPS/PostCom-T3-6	PRC. USPS
USPS/PostCom-T3-7	USPS
USPS/PostCom-T3-8	USPS
USPS/PostCom-T3-9	USPS

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-1. Please refer to page 6 of your testimony. Please provide the basis for your statement that pieces weighing more than 3.5 ounces "can and do run readily on ...older...generation scrting equipment."

RESPONSE:

The question takes my testimony wholly out of context and, indeed, truncates the sentence it purports to quote. That sentence reads in its entirety as follows:

> However, it is manifestly unfair to mailers, and shortsighted by the Postal Service, to require mailers to pay the rates applicable to flats for pieces that can and do run readily on both older and next generation sorting equipment.

The bases for this conclusion may be summarized as follows. **As I** state elsewhere in the same paragraph of that testimony, "the Postal Service has acknowledged that it has deployed letter sorting equipment that can process letters up to six ounces, so long as the piece othenvise meets the external dimensions of a letter (with some preparation constraints). Further, the Postal Service has acknowledged that some of the "older" generation sorting equipment is being retrofitted in this fashion. Thus, both older and next generation sorting equipment are and will be used to process letter shaped pieces that exceed 3.5 ounces and in fact exceed the maximum weight of heavy letters contemplated by Postcom's proposal.

Finally, as a practical matter, it is difficult to credit the proposition that an increase in weight of up to a maximum of half an ounce in the definition of a

2

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

heavy letter will significantly degrade the day-to-day operational efficiency of the

Postal Service's letter sorting equipment. The Postal Service has acknowledged

that it has not performed any recent studies on either older or new generation

equipment to support this proposition.

3

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-2. Please refer to your testimony at page 2, lines **20-21**
where you state that "heavier solicitation letters – 'heavy letters' – can generate
business for the Postal Service through a multiplier effect through the mail
stream".

a. Please confirm that, given the quality of the advertising and the targeting of the
recipient, the same can be said for advertising in lighter-weight letters.

b. Please confirm that there is no apparent limit to the principle underlying your
proposal. Are there limits to the additional weight of advertising after which the
multiplier effect for incremental inserts is weakened?

RESPONSE:

a.　　Only if advertising in lighter-weight letters is cost effective. The idea

behind advertising in heavy weight letters is being able to include advertising or

coupons that ordinarily (due to cost) would not have been feasible to include

b.　　Not confirmed. There is a clutter factor: the consumer may be **so**

overwhelmed by too many advertisements and coupons that he is not able to

focus on any of the advertising or coupons and discards the mailing in its

entirety. There are limits to the additional weight of advertising after which the

multiplier effect of incremental inserts are weakened.

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-3. Please refer to your testimony at page 3, lines **1-2** where you state, "the existing pricing structure discourages adding additional inserts or additional coupons above the breakpoints, and therefore artificially constrains the use of mail as a marketing and delivery medium."

a. Would you agree that the positive effects you describe from including additional advertising material would accrue regardless of the class of mail *to* which the advertising material is added?

b. If your response to part a is affirmative. **would** you suggest that the weight limits for every subclass or rate category of mail be relaxed from their current artificial constraints to permit advertising matter to result in a mailpiece over the limit set for that subclass or rate category?

c. Should the Postal Service relax the weight limits for any and all additional content, or just for advertising materials?

d.   What mechanism should the Postal Service use to determine if the weight limit was exceeded by the inclusion of additional advertising matter or by the inclusion of additional correspondence **or** mail matter?

RESPONSE:

a.   Certain types of mail produce a much greater rate of return for the Postal

Service than others do. So, it would depend on the mail class, the content of the

mailing and the advertising content. For example, an advertisement would

probably not work well as an insert with an IRS Audit Letter.

b.   Only to the extent that it would make sense *to* do so and be mutually

profitable for the mailer and the Postal Service.

c.   The Postal Service should relax the weight limit 'or any materials that

would result in additional or residual mail to the Postal Service to the extent it

would make sense *to* do so.

3

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

d.   Please see my response to USPS/PostCom-T2-1. I do not believe there

is any need for a mechanism, other than weight. The content of the mail has no

effect on Postal Service operations or revenues and **is** best left to normal

operation of the marketplace; marketers may use the additional .5 ounces **for** an

additional promotion in some cases or for a more detailed explanation of the

basic offering or for other legitimate purposes. Whatever the use, USPS will

benefit overall from the multiplier effect and additional volume.

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-4. Please refer to your testimony at page 3, lines **4-6**

where you state, "all available information suggests that heavier letters can run

efficiently on the Postal Service's newer letter automation equipment." Please

provide references to this material in this docket or elsewhere.

RESPONSE:

See my response to USPS/PostCom-T3-1. Also, please see the

testimony of Witness Godfred Otuteye, POSTCOM-T-8.

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-5. Please refer to page **4** of your testimony at lines 2-5
where you state, "the increase in the maximum weight for automation and ECR
rates letters to 3.5 ounces made it more economically feasible for many direct
marketers (including Bookspan) to expand their mailing efforts on developing
new markets, new lines of business, and new products." Please provide the
basis for this statement, framing your response in terms of additional mail
volume, higher response rates, etc. Please also indicate which pieces of
supporting material are unique to Bookspan and which are of broader implication
to other industries.

RESPONSE:

The increased weight allowance will permit the development of new

markets and products thereby creating additional volumes across all other

classes of mail.

One of BOOKSPAN's predecessors, Doubleday Book & Music Clubs, Inc.

(DMCI) used the increase to the automated letter weight to develop a large

member base for CROSSINGS@ our Christian family interest book club. The

increase in automated letter weight provided a discount opportunity that allowed

DMCI to cost-effectively include inserts promoting CROSSINGS@ in its existing

member promotional mailings, as well as promote the club through inserts in

promotions for related products. CROSSINGS@ is approximately 850,000

members strong today, which translates into a considerable amount of First-

Class Mail, Standard Mail and Package Service Mail. This is something that

would have been very difficult, if not impossible, without the increase in the

automated letter weight.

Using the mail as a business development medium works for the mailer

and for the Postal Service by producing profit generating volumes for both

6

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-6. Please refer to your testimony at page 4, line 6 where
you state that an increase of the maximum weight to **4.0** ounces "would have
equally beneficial effects."

a. Please provide the basis for this statement

b. Is a similar beneficial result possible above 4.0 ounces?

c. Is it your testimony that there are no diminishing returns to the inclusion of
additional advertising materials?

RESPONSE:

a.   The advertising content in **4.0** ounces would he at level where the

customer would not be over whelmed by the advertising content. Direct

marketers could still insert without seeing *a* drop *off* in responses.

b.   It is very probable.

c.   No, I believe there is a margin of diminishing returns to the inclusion of

additional advertising materials.

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-7. Please refer to line 9 of page **4** of your testimony where
you state that "New mail-based product markets indirectly lead to new mailing
lists". Is this true only as a result of the additional advertising material permitted
by an increase in the maximum weight? Please fully explain your answer.

RESPONSE:

Yes, the increased weight allowance will permit the development of new

markets and products thereby creating new lists and additional mailings. Without

the increased weight allowance the development of new markets and products

may not have been economically feasible especially for the products or markets

that are iffy.

Since 1990, BOOKSPAN has launched a total of four successful, targeted

clubs to Evangelicals, African Americans, and Hispanics (two). Each club

provides a carefully screened list of readers. Each listed rented by another

marketer leads to an immediate mailing by such marketer-and many further

mailings to those who positively respond to **the** offer.

a

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-8.   Please refer to your testimony at page 7, lines 1-3
where you state, "heavy letters were instrumental in producing multiplier volumes
when the Postal Service increased the maximum weight for automation and ECR
rates letters to 3.5 ounces." Please provide the basis for this statement,
including all analyses and data used to develop the conclusion.

RESPONSE:

For example, see my response to USPS/PostCom-T3-5. The members of

Bookspan's CROSSINGS® continue to produce mail volume for the Postal

Service

RESPONSE OF POSTCOM WITNESS POSCH TO INTERROGATORY OF THE
UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T3-9. Please confirm that you supported the extension of the
weight limit from 3.3 to 3.5 ounces. Please confirm that in FY2005, less than
0.2% of Standard Regular automation letters fell into this weight increment.

RESPONSE:

Yes, I did support the extension of the weight limit from 3.3 to 3.5 ounces

for the same reasons I have stated in my written testimony in support of the

extension to 4.0.

I do not have access to the data I would need to confirm that in FY 2005,

less than 0.2% of Standard Regular automation letters fell into this weight

increment. As I stated in my written testimony at page 3 lines 1-3 "the existing

pricing structure discourages adding additional inserts or additional coupons

above the breakpoint, and therefore artificially constraints the use of mail **as** a

marketing and delivery medium."

1   CHAIRMAN OMAS: Is there any additional

2   written cross-examination for Witness Posch?

3   (No response.)

4   CHAIRMAN OMAS: There being none, Ms.

5   Brickman, you may proceed to your next witness.

6   MS. BRICKMAN: Thank you, Mr. Chairman.

I   Witness Horowitz was scheduled to appear this morning,

8   and I was informed that there would be no cross-

9   examination of Mr. Horowitz. Therefore, he is not

10 here in the hearing room this morning.

11   I do have with me two copies of his direct

12 testimony and the responses to his interrogatories,

I> and I do have a certificate of authenticity attached

14 to each of these documents, or I'm momentarily

15 attaching them, and, at this time, I would move that

16 his testimony be admitted into the record.

17   CHAIRMAN OMAS: Is there any objection?

18   (No response.)

19   CHAIRMAN OMAS: There being none, Ms.

20 Brickman, would you please provide the reporter with

21 two copies of the corrected direct testimony of Aaron

22 Horowitz? That testimony is received into evidence.

23 However, as is our practice, it will not be

24 transcribed.

25 //

1   (The document referred to,

2   previously identified as

3   Exhibit No. PostCom-T-6 and

4   was received in evidence.)

5   CHAIRMAN OMAS: Ms. Brickman, have the

6   answers to the designated written cross-examination

7   been reviewed and corrected?

8   MS. BRICKMAN: Yes, Mr. Chairman. There are

9   no corrections at this time.

10   CHAIRMAN OMAS: There being no corrections,

11   please provide two copies of the corrected designated

12   written cross-examination of Witness Horowitz to the

13   reporter. That material is received into evidence and

14   is to be transcribed into the record.

15   (The document referred to,

16   previously identified as

17   Exhibit No. PostCom-T-6 was

18   received in evidence.)

19   //

20   //

21   //

22   //

23   //

24   //

25   //

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2006   Docket No. R2006-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF ASSOCIATION FOR POSTAL COMMERCE
WITNESS AARON HOROWITZ
(PostCom-T-6)

<u>Party</u>   <u>Inlerroaalories</u>

Postal Rate Commission   USPS/PostCom-T6-5, 9

United States Postal Service   USPS/PostCom-T6-1-18

Respectfully submitted,

Steven **W** Williams
Secretary

INTERROGATORY RESPONSES OF
ASSOCIATION FOR POSTAL COMMERCE
WITNESS AARON HOROWITZ (T-6)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designating Parties
USPS/PostCom-T6-1	USPS
USPS/PostCom-T6-2	USPS
USPS/PostCom-T6-3	USPS
USPS/PostCom-T6-4	USPS
USPS/PostCom-T6-5	PRC, USPS
USPS/PostCom-T6-6	USPS
USPS/PostCom-T6-7	USPS
USPS/PostCom-T6-8	USPS
USPS/PostCom-T6-9	PRC, USPS
USPS/PostCom-T6-10	USPS
USPS/PostCom-T6-11	USPS
USPS/PostCom-T6-12	USPS
USPS/PostCom-T6-13	USPS
USPS/PostCom-T6-14	USPS
USPS/PostCom-T6-15	USPS
USPS/PostCom-T6-16	USPS
USPS/PostCom-T6-17	USPS
USPS/PostCom-T6-18	USPS

RESPONSE OF POSTCOM WITNESS HOROWiTZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T6-1 Please provide the calculations that support the 47% postage increase figure reported on page 6 of your testimony. What would the comparable figure be if Cosmetique's current average unit postage were used as the base for the comparison?

RESPONSE:

The current postage for a parcel weighing 15.85 ounces mailed at

Standard regular rates, non-barcoded. and dropshipped to the BMC is $1.027

The USPS's rate proposal would increase the postage for a barcoded

parcel to $1.51 which is an increase **of** $0.483.

$0.483/$1.027 = 47.03%.

A comparison of non-barcoded to non-barcoded parcels with the other elements

being the same is as follows:

The current USPS rate is $1.027.

The USPS's rate proposal would increase the postage for a non-barcoded

parcel to $1.56 which is an increase of $0.533.

$0.533/$1.027 = 51.90%

A comparison of barcoded to barcoded parcels with the other elements being the

same is as follows:

The current *rate* is $0.997,

The USPS's rate proposal would increase the postage for a barcoded

parcel to $1.51 which is an increase of $0.513

$0.513/$0.997 = 51.45%

2

RESPONSE OF POSTCOM WITNESS HOROWITZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

If the term current average unit postage is inquiring regarding unit postage

increases across all the classes of mail Cosrnetique uses, the 47% postage

increase figure cited in my testimony pertains to the parcels product shipments.

RESPONSE OF POSTCOM WITNESS HOROWITZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T6-2 Please refer to page **5** of your testimony, lines 13-14.
Do Cosrnetique's retail competitors have [or] incur types of costs that
Cosmetique does not? Please explain fully.   [Corrected question.]

RESPONSE:

Yes, businesses that sell through retail incur types of costs that

Cosmetique does not. For example, these costs include labor costs for

salespeople. Postage is not the only type of cost that Cosmetique incurs that

retail businesses do not. For example, Cosmetique incurs costs relating to mail

processing and payment processing.

A

RESPONSE OF POSTCOM WITNESS HOROWITZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T6-3 Please refer to page 5 of your testimony, lines 16-19

(a) Please describe whether Cosmetique's current average unit postage
increased between July 1,2002 and January 7,2906. If so, please describe the
nature and cause of any such postage increases.

(b) Please confirm that a 15.85 ounce machinable Standard Mail Regular parcel
that is drop shipped to the DBMC would pay postage of $1.51 under the Postal
Service's current rate proposals.

(c) Please confirm that the residual shape surcharge is a rate element, not a total
price, and that prices for individual packages did not increase by 240%.

(d) Please provide your understanding of the reasons that the Commission has
recommended the residual shape surcharge for Standard Mail parcels.

(e) Please provide your understanding of why the residual shape surcharge has
been increased at an above-average pace.

RESPONSE:

(a)   None, the Postal Service did not increase postage during the period in

question. However, other directly related costs such as the cost to transport

parcels to the bulk mail centers did increase.

(b)   Confirmed.

(c)   Confirmed.

(d-e)   PostCom objects to these questions on the grounds that the questions call

for legal conclusions. Without waiving its objections, PostCom provides Witness

Horowitz's response as follows:

I am advised that the Commission has articulated its reasons for

recommending both the residual shape surcharge for Standard Mail parcels and

the increases to that surcharge in its opinions and recommended decisions

Such decisions speak for themselves.

5

RESPONSE OF POSTCOM WITNESS HOROWITZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

USPSIPOSTCOM-T6-4 Please refer to page 6 of your testimony at lines 11-18.

Please provide Cosmetique's shipping and handling charges that have been in

effect since 1999 showing, for each charge, the dates the charge was in effect.

RESPONSE:

The shipping and handling amounts charged by Cosmetique since 1999 are

shown below. The dates shown are the starting date when the higher amount

became the control or standard offer.

New Members

January 1999 - May 2001	$2.95
June 2001 - July 2003	$3.95
August 2003 - June 2006	$4.95
July 2006 - present	$5.95

Continuing Members

For members who joined Cosmetique with a shipping and handling charge
of $2.95, Cosmetique has not increased the shipping and handling.

For members who joined Cosmetique with a shipping and handling charge
of $3.95, Cosmetique increased the shipping and handling charges to $4.95 in
around July 2005.

For members who joined Cosmetique with a shipping and handling charge
of $4.95, Cosmetique intends to increase the shipping and handling charge to
$5.95 by the end of 2006.

RESPONSE OF POSTCOM WITNESS HOROWITZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

For members who joined Cosrnetique with a shipping and handling charge

of $5.95, Cosmetique has no current plans on increasing the shipping and

handling charge.

RESPONSE OF POSTCOM WITNESS HOROWITZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T6-5 Please refer to page **8** of your testimony, lines **1** to 3.

(a) Please explain why Cosmetique would curtail its use of the mail as a
marketing channel due to the proposed rate increases for Standard Mail parcels.

(b) Is your testimony asserting that if Standard Mail parcel prices were not
increased that Cosrnetique would not "expand our exploration of alternative
media channels to obtain customers"?

(c) Is it your testimony that alternative media channels are likely to be less
expensive than the mail? If so. why hasn't Cosrnetique used them more
extensively heretofore? If not, is Cosrnetique's objective to lower its postal costs,
even if its overall expenses increase? Please explain your answer fully.

RESPONSE:

(a)   The decision to market in any given channel or list is based on the

profitability of that channel or list. Profitability is based on the revenue generated

minus the costs of acquisition and fulfillment. One of the costs of fulfillment is

postage. Where there is an increase in the costs of postage, the overall revenue

needed to make a channel profitable also increases.

Further, if only the postage for fulfillment were to increase, then the

relative increase for profitability for all marketing channels would remain the

same. However, with the proposed postage rate increase, the increase for the

mail marketing channel increases for both the acquisition and fulfillment pieces.

For Cosmetique, mail as a marketing channel for new member acquisition

has been less profitable relative to other marketing channels. The increase in

postage would further reduce the profitability of the mail channel

RESPONSE OF POSTCOM WITNESS HOROWITZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

(b)   The lower profitability of a marketing channel leads any company to

consider alternative marketing channels. The marginal profitability of mail as a

marketing channel for Cosmetique has led Cosmetique to consider alternate

channels. Any decrease in the profitability in the mail channel only pushes

Cosmetique to explore alternate media channels that much faster.

(c)   The decision to use a marketing channel for acquisition is based on the

total profitability of that channel. While alternate media channels are clearly less

expensive in the acquisition process (i.e. it costs significantly less to send out an

e-mail than a direct mail piece), the value of a channel cannot be measured by

this one measure alone. Other measurements are needed, such as response

rates, payments rates, continuation rates, lifetime value of the members, etc.

Cosmetique has experience using mail as a marketing channel. We do

not have a similar long term experience using these alternate media channels.

However, given our historically lower profitability with mail as marketing channel

and the very large disparity between the costs of producing and sending out mail

as compared to the alternate media channels, we believe that the alternate

channels will prove to be more profitable.

We believe there will always be a place for mail as a marketing channel.

The issue is one of mix: how much of the marketing budget we will spend on

mail versus alternate media channels,

RESPONSE OF POSTCOM WITNESS HOROWITZ TO INTERROGATORY OF
THE UNITED STATES POSTAL SERVICE

USPS/POSTCOM-T6-6 Please provide the average density of a typical
Cosrnetique 15.85 ounce parcel. If that figure is not available, please provide the
external dimensions (length, width, height) of one or more typical shipping boxes
for a Cosmetique parcel.

RESPONSE:

The external dimensions of a typical shipping box for a Cosmetique parcel

are:

Length	9.25 inches
Width	6.50 inches
Height	2.25 inches

Although the weight and size of the parcel are typical, the contents of the box

varies.

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/Postcom-T6-7. Please refer to page 3, lines 22-23, through page **4,** lines
1-2 of your testimony where you state, "More recently, our mix of new members
have increasingly come from marketing channels that do not require the use **of**
the mail to join, such as (1) the Internet, (2) in-bound telemarketing and (3) direct
response television." Please indicate the relative costs of acquiring new
members through each of these channels and compare them to the costs of
acquiring customers through direct mail.

RESPONSE:

It is difficult to compare the relative costs of acquiring new members in different

marketing channels because of the different cost drivers *of* the channels. i.e. the use **of**

outside versus inside resources to perform various functions and the accounting for

those activities.

Nevertheless, I can provide the following information. Without including any

internal costs, direct mail is the most expensive channel for new member acquisition.

Direct mail is approximately 20% more expensive than direct response television for new

member acquisition. While we currently do not engage in new member acquisition

through telemarketing, direct mail is approximately twice as expensive as telemarketing

for reinstate or reenrollment.

Moreover, the relative cost of the acquisition itself is not the best measurement.

The best measurement is the profitability of a marketing channel. If it costs more to

acquire **a** new member in a particular marketing channel, those members need to

generate more revenue than a member who joins via a less expensive maiketing

channel

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/Postcom-T6-8. Please refer to your testimony at page 5, line 19 where you note that the RSS was 10 cents per piece when first imposed in 1999.

a. Please confirm that when the RSS was imposed, the Postal Service offered evidence that the actual cost difference was 35 cents (see, for example, USPS-T-36, page 13, line 11, Docket No. R97-1), but that the full impact was not being imposed due to the desire to mitigate rate impact. If you do not confirm, please explain.

b. Please confirm that the 24.2 cents cited in your testimony at page 5, line 20, is still less than the original cost difference **of** 35 cents.

(a-b)   I am not familiar with the Postal **Service's** *cost* data.

3

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/Postcom-T6-9. Please refer to your testimony at page 7, lines 7-9 where
you state that "it costs us more to drop enter our psrcels at some West Coast
bulk mail centers than we save in the drop entry discount."

a. Please confirm that efficiency arguments, such as Efficient Component Pricing
(please refer, for example, to the testimonies of witness Panzar or Sidak in this
docket), suggest that the lowest cost provider – whether it be the USPS or the
customer – should be performing the activities. **If you** do not confirm, please
explain.

b. Please confirm that efficiency is supported if, because a mailer cannot
dropship items at a lower cost than the Postal Service can transport such items,
the mailer discontinues dropshipping those items. If you do not confirm. please
explain.

RESPONSE:

(a)   Confirmed, however I do not believe that the Postal Service is in facl the lowes!
cost provider of these services. See my response to (b).

(b)   Not confirmed. The cost of actually transporting parcels to the bulk mail center is
just one of the activities (and costs) that comprise the drop shipping process. **The** entire
operation of how to organize the fulfillment process, including the picking and packing of
orders, the printing of invoices and sorting of the orders must all be considered in
determining the most efficient flow. For example, it is more efficient and cost effective
for Cosmetique to drop ship to the West Coast BMCs even though the actual
transportation costs exceed the postal drop ship discounts.

In addition, a mailer may choose a higher cost alternate in order to gain other
advantages such as speed of delivery

4

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/Postcom-T6-10. Please refer to page 8 of your testimony at lines 1-3 where you state, "As a result of the price increases, we will have to curtail our use of the mail as a marketing channel and expand our exploration of alternative media channels to obtain customer, and explore other ways of delivering our products to our members."

a. Please clarify whether the costs to you of advertising through other media have increased, decreased, or stayed the same over the past five years.

b. Please provide a list of the alternative ways that your products may be delivered to your members and provide an indication of relative costs when compared to using Standard Mail.

RESPONSE:

(a)   In general, the costs to Cosmetique of advertising through other media have

decreased over the past five years where the same marketing activity is being

performed. For example, if Cosmetique **placed** the same volume of advertising in

Sunday supplements, the cost has decreased. However, if Cosmetique changed the

marketing program such as the mix of the advertising (tests versus rollout programs) or

reduced quantities, the costs may have increased, decreased or stayed the same.

       This is consistent with other vendors Cosmetique uses. The costs charged by

other vendors have decreased for the same item or activity over the past five years

assuming no changes.

(b)   Cosmetique could look to use alternate delivery companies, such as Federal

Express or United Parcel Service to deliver our collections to our customers.

Cosmetique has not obtained definite quotes from any company in order to provide a

comparison *of* costs versus the Postal Service. However, Cosmetique would expect the

cost of the delivery alone would be higher with the use of alternate delivery companies,

5

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
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without considering other internal costs or savings, nor considering the perceived higher

value that members may have with alternate delivery.

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
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USPS/Postcom-T6-11. Please refer to page 8, lines 5-7 where you state, "our return on investment from mail marketing channels will be reduced to the point where the mail will no longer be a profitable marketing channel for us."

a. Please provide an explanation of the decision process which would lead to this conclusion, including the variables considered and the timeframe over which this decision would be set into motion.

b. Please confirm that by "mail marketing channels" you are referring to ads included in the shipments of your product to customers. If you do not confirm, please explain.

RESPONSE:

(a)   As mentioned in my response to interrogatory USPS/POSTCOM-T6-7, the profitability of each marketing channel is reviewed to determine whether to increase, decrease or stop marketing in that channel in the future. Profitability compares the cost of the channel against the revenues received.

Profitability is actually reviewed on **a** campaign by campaign basis within a marketing channel, and even on a segment **by** segment basis within a campaign. Certain segments may do very well, well, fair, poor, or not break even at all. Those segments that are not profitable are not marketed to again.

As costs increase, the revenue needed to continue with that marketing campaign increase as well. Costs can increase on a unit basis or because of a **loss** of economies of scale. For example, Cosmetique is charged a lower per unit cost to produce a mailing of 1 million pieces versus a mailing of 50,000

When only a few segments of a campaign remain profitable, the entire campaign may no longer be viable because of increased costs resulting from the loss of the economies of scale in producing the campaign. In other words, while there may still be some segments that are profitable if all the segments were marketed, the few profitable

7

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
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segments would no longer be profitable when the unprofitable segments are not

marketed. The same logic applies to marketing channels.

Cosmetique does not know whether the return on investment from mail

marketing channels will, in fact, be reduced where Cosmetique will no longer engage in

that marketing channel. Thus, Cosmetique does not have any timetable as lo when (or

if) Cosmetique will stop using the mail marketing channel. However, as the costs

increase in the mail marketing channel, the revenue needed from the channel increases

as well.

(b) Not confirmed. By "mail marketing channel," I am referring to any marketing

activity which primarily uses the mail to present the offer to the potential member and/or

receive the order from the member. Among other activities, this means direct mail,

package inserts, Sunday supplements, etc.

a

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
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USPS/Postcom-T6-12. Please refer to lines 9-11 of page 8 of your testimony
where you state that you "have begun a marketing initiative to reinstate members
through electronic mail and through our website."

a. Please reconcile this statement with your testimony, for example on page 4,
that First-class Mail is used to sign up members, send invoices, etc.

b. Please confirm that this marketing initiative has been underway independent of
the outcome of the current rate case.

c. Please confirm that the "multiplier effect" of your product mailings is weakened
when the bill payment, marketing *efforts,* customer sign-ups are conducted via an
electronic method.

RESPONSE:

(a)   I see no inconsistency to be reconciled. On page **4** of my testimony I explain:

> For those customers who choose the open account pay
> method, First Class mail is used for payments and dun
> letters. We have found that members who join
> Cosmetique through the mail are more likely to be open
> account members as compared to members who join via
> electronic media. Members who join via electronic media
> generally pay with a credit card. Thus any reduction in the
> volume of acquisition through mail marketing channels will
> reduce the overall volume of mail, particularly First Class
> mail.

On page **8,** I simply state "Cosmetique has begun a marketing initiative *to*

reinstate members through electronic mail and through our website." The marketing

initiative I refer to here is testing the use of electronic media for certain activities,

including the reinstatement of members.

(b)   Confirmed. The tests have not been completed. However, assuming there are

favorable results, the relative profitability (revenue minus cost) would affect the speed at

which Cosmetique would adopt the marketing actions being tested.

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(c) Not confirmed. The question confuses the issue. **As** I interpret the question, by "product mailings," you are referring to the packages of product that we send to our customers. The "multiplier effect" of these packages is the additional mail volume that occurs as a result of additional sales of our own products and third party products or services and related correspondence that is generated from inserts in these packages. These inserts constitute a "marketing effort" that is conducted via the mail. **A** "customer signup" and "bill payment" generated from an insert may be conducted via mail or via an electronic method, but customers who respond to a mailed solicitation such as an insert frequently order by mail and pay their bills by mail. (See (a) above.)

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USPS/Postcom-T6-13. Please refer to your statement at lines 17-18 of page 8 that "each of these trends [toward electronic substitutes for mail] will accelerate dramatically in the near future, especially if the proposed postage rates for Standard Mail are implemented." If Standard Mail rates were not increased at all, would these trends continue to "accelerate dramatically," accelerate, stay stable, or decrease? Please provide any analysis used to arrive at your conclusion.

RESPONSE:

I would expect that the trends toward the use of electronic media **will** occur

regardless of whether Standard Mail rates increase. The question is the speed at which

it will occur. The higher the costs of mail, the faster the trend will be. This is so because

companies like Cosmetique consider the relative profitability of our decisions. Where the

cost for one action is higher than another and the revenue is the same, we will take the

lower cost action

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/Postcom-T6-14. Please refer to your testimony at page 9, lines 2-4
where you state, "**As** the cost differential between the Postal Service and other
services narrows, we will increasingly be willing to use other shipping providers
who can guarantee the faster level of service sought by single-sale buyers."
Please provide, if not actual rate comparisons, indications of the **cost** of these
other service providers relative to the prices your would pay under Standard Mail
and indicate what shipping and handling charges you would then charge the
single-sale buyers for such shipments.

RESPONSE:

Cosmetique would expect the cost of the delivery alone would be higher with the

use of alternate delivery companies, without considering other internal costs or savings.

nor considering the perceived higher value that members may have with alternate

delivery.

Hypothetically and only considering the variables of cost and perceived value, if a

customer perceives a $2.00 increased value in receiving a Cosmetique collection via an

alternate delivery company as compared to the Postal Service, and if the postal cost is

more than $2.00 lower than the cost of the alternate delivery company, Cosmetique will

choose the Postal Service. However, if the gap between the postal cost and the

alternate delivery cost narrows to less than $2.00, Cosmetique will choose the alternate

delivery company.

As the cost of delivery (as one item within the larger costs associated with

shipping and handling) increases, Cosmetique must make a decision whether to

increase shipping and handling charges. If the cost of delivery through an alternate

delivery company were so much higher than the Postal Service (or if the Postal Service

raises its rates *so* much higher than current rates), Cosmetique considers whether to

increase shipping and handling charges to cover the additional *cost* balanced against

the loss of members and sales as a result of the increased cost. Since Cosmetique

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
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does not know the **cost** of delivery from a alternate delivery company, I cannot answer

what Cosmetique would charge.

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OF THE UNITED STATES POSTAL SERVICE

USPS/Postcom-T6-15. Please refer to your testimony at page 10, lines 23-24, through page 11, lines 1-3 regarding the permission to include "non-print" materials in Bound Printed Matter. Is it your understanding that the inclusion of these materials is permissible if the weight limit of 15 pounds is exceeded?

RESPONSE:

No.

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
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USPS/Postcom-T6-16. Please refer to your testimony at page 11, lines 4-8.

a. Did Cosmetique determine the materials to be included in its packages independent of the Standard Mail weight limit of 16 ounces? Or did Cosmetique determine the materials to be included in its packages with consideration given to the 16-ounce limit?

b. If the Postal Service were to change the weight limit of Standard Mail to 13 ounces to be consistent with First-class Mail's weight limit, would Cosmetique change the content of its packages?

c. If the Postal Service were to change the weight limit of Standard Mail to 1 ½ pounds, would Cosmetique change the content *of* its packages?

RESPONSE:

(a)   Cosmetique determines the products and other material to be included in the

package with great consideration given lo the **16** ounce limit.

b)   Yes. Cosmetique would probably have *to reduce* the number of products we

send to our members in each collection. This would have a huge negative impact on

Cosmetique. Among other things, I believe we would mail out fewer collections which

would result in a decrease in the mail volume Cosmetique generates

c)   Yes. Cosmetique would probably increase the number of products we send lo

our members in each collection. This would have a huge positive impact on

Cosmetique. Among other things, I believe we would mail out more collections which

would result in an increase in the mail volume Cosmetique generates

15

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/Postcom-T6-17. Please refer to your testimony on page 11, lines 9-20 where you suggest that "ride alongs" should be permissible even if they increase the weight of the mail piece above its limit.

a. Would you agree that the positive effects you dascribe from including additional advertising material would accrue regardless of the class of mail to which the advertising material is added?

b. If your response to part (a) is affirmative, would you suggest that the weight limits for every subclass of mail be relaxed from their current "rigid approach" to permit advertising matter to result in a mailpiece over the limit set for that subclass?

c. Should the Postal Service relax the weight limits for any and all additional content, or just for advertising materials?

d.   What mechanism should the Postal Service use to determine if the weight limit for Standard Mail was exceeded by the inclusion of additional advertising matter or by the inclusion of, for example, additional cosmetic products?

(a)   I would not agree. The class of mail is not the determining factor as to the

positive effects of a ride-along. The question is the relative cost of the increased

postage to pay for the ride-along as compared to the revenue generated by including the

ride-along, and comparing that net revenue of including ride-alongs against the cost of

not including the ride-along at all.

Thus, I believe that Standard mail has a unique rate structure that would allow for

ride-alongs without the increased postage being greater than the revenue generated

from the ride-along, and the overall postage rate minus the additional ride-along revenue

would not be greater than the postage rate if the ride-alcng was not included at all.

(b)   See the answer to (a)

16

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
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(c)   My proposal does not look to increase the weight limit for the actual producl

being sold

(d)   One possible mechanism to determine if the weight limit for Standard Mail was

exceeded would be to have the additional advertising material in a separate envelope.

The package could be weighed with and without the separate envelope.

RESPONSES OF POSTCOM WITNESS HOROWITZ TO INTERROGATORIES
OF THE UNITED STATES POSTAL SERVICE

USPS/Postcom-T6-18. Please refer to your response to USPS/Postcom-T6-1
and USPS/Postcom-T6-4.

a. Please confirm that the proposed postage for a typical Cosmetique parcel
drop-shipped to a BMC, $1.51, is $4.44 less than Cosmetique's current "standard
offer" shipping and handling charge of $5.95 and that the proposed postage is
only 25.4 percent of the shipping and handling charge.

b. Please confirm that the proposed postage for a typical Cosrnetique parcel
drop-shipped to a BMC, **$1.51,** is $1.44 less than Cosmetique's lowest shipping
and handling charge currently charged to customers who have joined
Cosmetique within the last 7 and a half years, and confirm that the proposed
postage is only 51.2 percent of Cosrnetique's lowest shipping and handling
charge for said customers.

c. Please confirm that on January 10, 1999 the postage for a typical 15.85 ounce
Cosmetique parcel that was Basic presorted and drop-shipped to a BMC was
$0.856.

d. Please confirm that Cosmetique's shipping and handling charges have
increased by 102 percent since January of 1999 to the present, whereas under
the Postal Service's pricing proposals, the postage **fo:** a typical Cosmetique
parcel described in part (c) would have only increased 76 percent over the same
seven and a half years.

(a -d)   Confirmed. However, the postage cost for an outbound package is not the only

cost incurred by Cosmetique associated with shipping and handling. For example,

Cosmetique incurs costs associated with mail preparation and drop shipping lo the BMC.

and Bulk Parcel Return Service.

POSTAL RATE COMMISSION
DOCKET NO. R2006-1
DECLARATION OF AARON HOROWITZ

I hereby declare, under penalty of perjury, that:

I prepared the interrogatory responses. which were filed under my signature and which have been designated for inclusion in the record in this docket; and

If I were to respond to these interrogatories orally today, the responses would be the same.

AARON HOROWITZ

DATE _____ 10/27/2007 _____

1   CHAIRMAN OMAS: Is there any additional

2 cross-examination for Witness Horowitz?

3   (No response.)

4   CHAIRMAN OMAS: There being none, thank you,

5 Ms. Brickman, and, Mr. Hollies, thank you very much

6 for your assistance.

7   MS. BRICKMAN: Thank you, Mr. Chairman.

8   CHAIRMAN OMAS: Mr. Baker, would you please

9 call our next witness?

10   MR. BAKER: Thank you, Mr. Chairman. The

11 Newspaper Association of America calls Allan T.

12 Ingraham.

13   CHAIRMAN OMAS: would you please raise your

14 right hand, Mr. Ingraham?

15   Whereupon,

16   ALLAN T. **INGRAHAM**

17   having been duly sworn, was called as a

18 witness and was examined and testified as follows:

19   CHAIRMAN OMAS: Please be seated.

20   Mr. Baker, you may proceed.

21   DIRECT EXAMINATION

22   BY MR. BAKER:

23   Q   Dr. Ingraham, I'm handing you two copies of

24 a document labeled NNA-T2 entitled "Direct Testimony

25 of Allan T. Ingraham" on behalf of the Newspaper

1   Association of America and ask you, was that prepared

2   by you under your supervision?

3   A   Yes, it was.

4   MR. BAKER: With that, Mr. Chairman, I move

5   its admission into evidence.

6   CHAIRMAN **OMAS:** Is there any objection?

7   (No response.)

8   CHAIRMAN **OMAS:** Hearing none, Mr. Baker,

9   would you please provide two copies of the corrected

10   direct testimony of Allan T. Ingraham to the reporter?

11   That testimony is received into evidence. However, as

12   is our practice, it will not be transcribed.

13   (The document referred to was

14   marked for identification as

15   Exhibit No. NNA-T-2 and was

16   received in evidence.)

17   MR. BAKER: Thank you, Mr. Chairman.

18   BY MR. BAKER:

19   Q   Dr. Inqraham, were there three library

20   references, Category II library references, submitted

21   with your testimony?

22   A   Yes, there were.

23   Q   Those are NNA/LRT-PC-1 and NNA/LRT-PC-2 and

24   NNA/LRT-2-3.

25   A   Correct.

1   Q   And those were prepared by you under your

2   supervision.

3   A   Yes, they were.

4   MR. BAKER: Mr. Chairman, I would also move

5   for admission into evidence those categories of

6   library references.

7   CHAIRMAN OMAS: Without objection, so

8   ordered.

9   (The documents referred to

10   were marked for

11   identification as Exhibit No.

12   NNA/LRT-PC-1, NNA/LRT-PC-2,

13   and NNA/LRT-2-3 were received

14   in evidence.)

15   CHAIRMAN OMAS: Mr. Ingraham, would you

16   please pull your mike a little bit closer to you,

17   please? That's good.

18   Mr. Ingraham, have you had an opportunity to

19   examine the packet of designated written cross-

20   examination that was made available to you this

21   morning?

22   THE WITNESS: Yes, I have, Mr. Commissioner.

23   CHAIRMAN OMAS: If the questions contained

24   in that packet were posed to *you* orally today, would

25   they be the same as those previously provided to the

1   Commission in writing?

2   THE WITNESS: Yes, they would.

3   CHAIRMAN **OMAS**: Are there any **correc**tions or

4   additions that you would like to make to those

5   answers?

6   THE WITNESS: No, sir.

7   CHAIRMAN **OMAS:** Counsel, would you please

8   provide two copies of the corrected designated written

9   cross-examination of Witness lngraham to the reporter?

10   That material is received into evidence and is to be

11   transcribed into the record.

12   (The documents referred to,

13   previously identified as

14   Exhibit No. NNA/LRT-PC-1,

15   NNA/LRT-PC-2, and NNA/LRT-2-3

16   were received in evidence.)

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2006   Docket No. R2006-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF NEWSPAPER ASSOCIATION OF AMERICA
WITNESS ALLAN T. INGRAHAM
(NAA-T-2)

Party	Interrogatories
Advo, Inc.	ADVO/NAA-T2-1-3, 4c, 5a. c, 6-9
Postal Rate Commission	ADVO/NAA-T2-1-2, 8
	USPS/NAA-T2-1, 3
United States Postal Service	ADVO/NAA-T2-1-3, 6-9
	USPSINAA-T2-1-4

Respectfully submitted.

_&.&_ —————

Steven W. Williams
Secretary

INTERROGATORY RESPONSES *OF*
NEWSPAPER ASSOCIATION OF AMERICA
WITNESS ALLAN T. INGRAHAM (T-2)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designating Parties
ADVO/NAA-T2-1	Advo. PRC. USPS
ADVOINAA-T2-2	Advo, PRC, USPS
ADVOINAA-T2-3	Advo, USPS
ADVO/NAA-T2-4c	Advo
ADVOINAA-T2-5a	Advo
ADVO/NAA-T2-5c	Advo
ADVOINAA-T2-6	Advo. USPS
ADVO/NAA-T2-7	Advo. USPS
ADVOINAA-T2-8	Advo. PRC, USPS
ADVOINAA-T2-9	Advo, USPS
USPS/NAA-T2-1	PRC. USPS
USPSINAA-T2-2	USPS
USPS/NAA-T2-3	PRC, USPS
USPSINAA-T2-4	USPS

NEWSPAPER ASSOCIATION OF AMERICA
WITNESS ALLAN T. INGRAHAM
ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T2-1-9)

ADVO/NAA-T2-1.   Please confirm that, in your rate design:

(a)   The ECR revenue requirement in your DAL_Conversion_to_On-Piece (75% Conversion) worksheet does not reflect any DAL cost savings from the conversion to on-piece addressing. If this is incorrect, please explain.

(b)   The saturation flat costs you used to develop the non-surcharged saturation flat rate is an average of the costs for all saturation flats plus all associated saturation flat DALs assumed to be in the system. If this is incorrect, please explain.

(c)   You did not adjust your second set of rates to achieve the USPS original goal of 213% cost coverage (or $3,142,557,985 in contribution to institutional cost -- per the original LR L-36). If this is incorrect, please explain.

(d)   The NECR rates in both of your rate design spreadsheets are simply derived from your ECR rate changes. You have made no specific adjustments directly purely at the NECR rates. If this is incorrect, please identify and explain the rationale for the specific adjustments you deliberately made to NECR rates.

Answer:

(a) Confirmed

(b) Confirmed.

(c) Confirmed that it was not my goal to achieve precisely the cost coverage presented in witness Kiefer's original version of LR L-36. Rather, I recognized that any rate design I proposed would have to achieve cost coverage that was at least reasonably consistent with the range of cost coverages implied by Kiefer's original and amended workpapers. I should note, however, that the upper bound of that "range" — that is, the cost coverage implied in Kiefer's revised version of LR L-36. is unrealistic. In

NEWSPAPER ASSOCIATION OF AMERICA
WITNESS ALLAN T. INGRAHAM
ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T2-1-9)

particular, Kiefer's revised testimony assumes that with a *1.5* cent DAL surcharge there

would be no conversion to on-piece addressing by ECR saturation mailers. As I

described on page 14 of my testimony, this is an unrealistic assumption.

    (d) Confirmed

NEWSPAPER ASSOCIATION OF AMERICA
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ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T2-1-9)

ADVO/NAA-T2-2. On page 16 (lines 11-12), you cite the principle of Efficient

Component Pricing (ECP) as your basis for applying 100% passthroughs of density-

related cost differentials to the comparable rate differentials (with the exception of basic

to high-density letters and the parcel rates)

(a) Do you agree with the principle of ECP as described by witness Sidak? Please explain.

(b) Do you believe that the cost differences between ECR basic, high-density, and saturation (by shape), used in your rate development, are due to entirely to differences in worksharing activities? Please explain.

(c) Is it your understanding that ECP ensures that each service being priced (under the ECP concept) generates an equal per unit contribution? Please explain.

Answer:

(a) Yes. As a matter of principle I believe that Efficient Component Pricing can

be used to accurately **set** worksharing discounts.

(b) I take this question to mean that within a specific grouping of mail, such as

ECR, cost differences between shapes are likely due to factors other than worksharing

If the question goes to different presort levels of the same shape, my understanding is

that these are due to worksharing.

(c) For the purposes of this response I presume "contribution" to refer to the

service's contribution to institutional cost.

3

NEWSPAPER ASSOCIATION OF AMERICA
WITNESS ALLAN T. INGRAHAM
ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T2-1-9)

As I understand the question. I believe this is correct when the opportunity costs of the separate services are equal. In particular, ECP is the sum of the input's direct per unit incremental cost and the opportunity cost to the monopolist of the sale of an additional unit of the service. Because the service's contribution to institutional cost would be its revenues less its volume variable costs, the contribution to institutional costs would equal the opportunity cost of that service to the monopolist

ADVO/NAA-T2-3. In several portions of your testimony, you refer to the use of DALs as an option or optional mail feature (page 3, line 8; page 6, line 13; page 12, line 14; page 16, line 2).

    (a)   In the USPS rate design, do you believe the saturation flat rate is lo be applied only to on-piece addressed flats? If not please explain.

    (b)   In the USPS rate design. **do** you believe that saturation flats with DALs are supposed to pay both the saturation flat rate plus the DAL surcharge? Please explain.

    (c)   In your rate design, is the saturation flat rate to be applied only to on-piece addressed flats? Please explain.

    (d)   In your rate design, are saturation flats with DALs to pay both the saturation flat rate **plus** the DAL surcharge? Please explain.

    (e)   Under ECP, when there is a separate rate for an optional feature, *is* **it** appropriate for the ratepayers not taking that option to cover the costs of that option in their rates? Please explain.

Answer:

    (a) No. It would be applied to all ECR saturation flats

    (b) Yes. They would pay both.

    (c) No, It would be applied to both on-piece addressed flats arid flats with DAL,

just as in the USPS rate design.

    (d) Yes. They would pay both

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ADVO, INC. (ADVO/NAA-T2-1-9)

(e) As a general rule of thumb, no, it is not. This was the purpose of my second

rate design, which reduces the rate of saturation ECR flats with on-piece addressing

based on an estimate of the costs avoided from DALs mailers that would adopt on-piece

addressing

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ADVO, INC. (ADVO/NAA-T2-1-9)

ADVO/NAA-T2-4. On page 18 (lines 8-11) you state that you " used [in your rate design] the current pound charge of 64 3 cents instead of the Postal Services proposed 64 1 cents, because to my knowledge witness Kiefer nowhere specifically explained why he proposed to change this charge."

(a)   Did NAA ask witness Kiefer anything about his proposed pound charge? Please explain.

(b)   In this case, did NAA obtain any data on weight-related ECR costs?

(c)   Did you, in any way, attempt to determine the extent of weight-related ECR flat costs? Please explain.

Answer:

(a) & (b)   Redirected to NAA

(c)   No.

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ADVO, INC. (ADVO/NAA-T2-1-9)

ADVO/NAA-T2-5. On pages 8 ff, you take issue with the fact that the USPS did not de-average the basic/high density flat delivery cost for use in its rate design. You state (page 10, lines 9-12): ". . .an appropriate rate design for ECR mail should use the data estimating the cost differences between the highdensity and saturation flats worksharing tiers.

- (a) Please confirm that neither the USPS nor you used a de-averaged high-density/saturation flat mail processing ccst in rate design. If this is incorrect, please explain.

- (b) Please confirm that NAA did not request de-averaging of the high-density/saturation flat mail processing cost for rate design purposes. If this is incorrect, please explain.

- (c) Under ECP, when there are separate rates for separate services. is it appropriate to base the rate differential on a cost differential that, in part. ignores service cost differences associated with a major cost category?

Answer:

(a) Confirmed

(b) Redirected to NAA

(c) Theoretically, one would prefer to base differences on any cost difference in a competitive category of activity. However, when applying theory in the real world. if one is not able to measure those cost differences with sufficient statistical accuracy, then one has no statistically valid cost differences to use when setting rates

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ADVO, INC. (ADVO/NAA-T2-1-9)

ADVO/NAA-T2-6. On page 21, you state that: ". . . I have calculated the incremental

cost of a DAL to be 0.75 1 cents per DAL. Therefore my proposed DAL surcharge

recovers that incremental cost and also would include an optional or value component."

    (a)   Please explain your concept of DAL incremental cost that led to this figure

    (b)   Please explain whether the 0.751-cent incremental cost applies to each of your two alternative rate designs.

    (c)   Please explain why only that amount of "incremental cost" must be recovered in your second alternative set of ECR rates and the remainder of the 1.4-cent surcharge is an optional or value component.

<u>Answer</u>:

    (a) Incremental cost of a service over any range of production is the total cost to

the firm including the production of that service (at some pre-selected level) less the

total cost to the firm including some different (presumably lower) level of production of

that service.

    (b) That cost calculation was used in my secord rate design

    (c) With an incremental cost of 0.751 cents, a surcharge of 1.4 cents per DAL

would exceed the incremental cost of the DAL. Because the surcharge exceeds the

incremental cost, the remainder could be considered a value price for an optional

product, which is what I understand DALs to be.

9

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ANSWERS TO INTERROGATORIES OF
ADVO, INC. (ADVO/NAA-T2-1-9)

ADVO/NAA-T2-7.   In response to VP/USPS-2, the USPS states that for the four-month period of March-June 2006. the following were accompanied by DALs: 7.7% of ECR high-density non-letter DDU pieces, 2.2% of ECR high-density non-letter DSCF pieces. and 2.6% of ECR high-density non-letter pieces. This means roughly 4.85% of all ECR high-density non-letters are accompanied by DALs.

(a)   Do the high-density flat costs you use in your rate design include the costs of DALs associated with high-density flats? Please explain.

(b)   Do the DAL conversions in your worksheet DAL_Conversion_to_On_Piece also reflect any high-density DAL conversions? Please explain.

(c)   In your first set of rates you propose the USPS proposed DAL surcharge of 1.5 cents. In the second set of rates you propose a surcharge of 1.4 cents. The USPS surcharge is intended for saturation **DALs.** Do your alternative proposed surcharges also apply only to saturation **DALs?** Please explain.

Answer:

(a) The high density flat delivery costs used in my analysis were provided by

witness Kelley in NAA/USPS-T30-7 and ADVO/USPS-T30-1   **To** the extent that those

figures include delivery costs for any DAL associated with high-density non-letters. then

yes.

(b) No. They affect saturation DALs

(c) They would apply only to saturation DALs, as does the USPS proposal.

Furthermore, it is my understanding that postal regulations do not permit high-density

mailers to use DALs.

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ADVO, INC. (ADVO/NAA-T2-1-9)

ADVO/NAA-T2-8. Witness Sidak states (pages 9-10, lines 19ff): "To promote such

[economic] efficiency, the Commission has applied ECP in setting discounts for

worksharing such as presortation and destination entry at, ideally, 100 percent of the

estimated avoided cost of the activity whose performance the Postal Service avoids.

This correct application of ECP advances economic efficiency by providing accurate

pricing signals to mailers and the Postal Service **A** deviation of pass-through rates

from 100 percent would result in postal rates that are inconsistent with the

general principles of ECP."

(d) If you agree with the principle of ECP, please explain why you did not pass
through 100% of the dropship-related cost avoidances to the dropship
discounts.

(e) Please confirm that by not passing through 100% of the dropship cost
avoidances to the discounts, the more discounted mail pieces are paying
a greater per piece contribution than the less discounted mail pieces. If
you cannot, please explain why not.

Answer:

(a) As stated on pages 8-9 and 13-14 of my testimony, the purpose of my

testimony was to correct what I believed to be the two largest shortcomings in the postal

services rate design. Those were (1) the unprecedented pass-through of delivery costs

for ECR saturation flats of 2200 percent and (2) the flawed implementation of the DAL

surcharge in the rate design. I designed my rates to correct these shortcomings, which

were the focus of my testimony.

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ADVO, INC. (ADVO/NAA-T2-1-9)

Although I recognized that USPS witness Kiefer passed-through in some instances only 85 percent of the calculated cost-savings from drop-shipping. I concluded that correcting the drop-shipping pass-through percents would have introduced a third issue that would distracted my testimony from its two most important goals. My not adjusting the dropship discount allows for a straightforward Comparison of my rate designs to those of the Postal Service. which changing the dropship discounts would have obscured. **As** a practical matter, the deviation of 85 percent from 100 percent, in my opinion, pales in comparison to either the deviation of 2200 percent from 100 percent or the lack of even a simple cost model used in the determination of the DAL surcharge.

(b) Presuming that costs avoided are measured accurately and the discounts set appropriately, then yes.

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ADVO, INC. (ADVO/NAA-T2-1-9)

ADVO/NAA-T2-9. On page **21,** lines 1-2, you state of your second alternative rate design: ." . . .under this proposal, the most common saturation flat (entered at the DDU) would pay no more than under Kiefer's design . ." Please confirm that on page 6. the DDU saturation flat rate proposed by the USPS is listed as 14.0 cents while your second alternative DDU saturation flat rate is 14.1 cents. If this is incorrect, please explain why.

<u>Answer</u>:

This line of text was meant **to** refer to saturation flats with DALs. When my

recommended DAL surcharge of **1 4** cents is considered, the prices of ECR saturation

Rats with DALs entered at the DDU are equal to those in Kiefer.

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ANSWERS TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE (USPS/NAA-T2-1-4)

USPS/NAA-T2-1.   Please refer to footnote 1, page 7 of your testimony.

Is it your view that, for the purposes of proposing and recommending rates under the Postal Reorganization Act, it is improper for the Postal Service and the Commission *to* consider non-cost factors that lead to the establishment of prices that might, in some circumstances, violate the principle of efficient component-pricing? Please support your view.

Answer:

No. I am aware that the statute directs the Postal Service and Commission to consider a number of non-cost factors in setting rates.

However, as it relates to worksharing discounts, I believe that following the principles of ECP is important, Even if non-cost factors are taken into account. those factors should adequately justify departing from ECP prices. Here, the Postal Service passed through 2200 percent of the cost difference between saturation and high density ECR flats—a cost difference determined by differences in delivery costs. I believe such a large passthrough is grossly inconsistent with proper rate setting. This proposal would grossly overcharge high-density mailers for access to the delivery system, which is exactly what ECP is intended to prevent.

Specifically, for the Postal Service to support this 2200 percent pass through (which deviates from the ECP pass through by 2100 percent) by appealing to non-cost factors, it must explain why those non-cost factors, whatever those may be, outweigh by 21 times the cost factors that affect the rate differential between high-density ECR flats and saturation ECR flats.

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THE UNITED STATES POSTAL SERVICE (USPS/NAA-T2-1-4)

USPS/NAA-T2-2.   Please refer to page **14,** lines 12-16 of your testimony

When considering the percentage change for the saturation category, is it appropriate for the Commission to consider the additional charge for using DALs. and the effect of the new surcharge? Please provide the basis for your answer.

Answer:

For this response I take "percentage change" to be the percentage increase in the price of ECR saturation flats from the current price of that mail type.

To the extent that the Postal Service currently considers the percentage increase in rate for any particular mail category in determining price, then yes. In this instance, however, it is appropriate for the Commission to take into account how many DALs are likely to be mailed, as I discuss at pages **13** to 16 of my testimony. This is **a** consideration the Postal Service has failed to make.

2

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ANSWERS TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE (USPS/NAA-T2-1-4)

USPS/NAA-T2-3.   Please refer to page 17 of your testimony

Please explain the ratemaking rationale for offering two different rate designs for ECR mail based solely on the level of expected response to the proposed DAL surcharge.

Answer:

As I stated on pages 8-9 and 13-14 of my testimony, I found two serious flaws in witness Kiefer's rate proposal for ECR mail. One of those flaws was the pass through of 2200 percent of the cost difference between ECR saturation and ECR high density flats. This flaw could be corrected with data provided by witness Kelley in both NAA/USPS-T30-7 and ADVO/USPS-T30-1.

The other flaw in witness Kiefer's rate proposal was the fact that he assumed that there would be no conversion from DALs to .on-piece addressing, despite ample reason to believe that at least some DALs would convert. Hence, his rates are based on an urealistic assumption about mailer behavior.

The amount of DAL conversion is relevant to both of these issues in the setting of high-density and saturation rates. So I believe that the Commission has to choose between two assumptions: (1) no **DAL** conversion (as Kiefer's revised testimony now assumes; or (2) some DAL conversion. My testimony presents improved rate designs based on both of these alternative assumptions. It is up to the Commission which assumption about DAL conversion to use, and the rates it sets should be based upon whichever assumption it uses.

3

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THE UNITED STATES POSTAL SERVICE (USPS/NAA-T2-1-4)

USPS/NAA-T2-4.   Please refer to Table 3 which is located on page 9 of your direct testimony. The ECR Saturation Flat cost cited in the column titled 'Kelley Response to NAA/USPS-T-30-7, 2006' is 5.226 cents. Please confirm that the unit delivery cost in the cell cited should be 5.213 cents based on Witness Kelley's response.

Answer:

Confirmed. I note, however, that my workpapers (NAA-LR-T2-1: Rate Design Workpapers (No DAL Conversion), NAA-LR-T2-2: Rate Design Workpapers (DAL Conversion to On-Piece) and NAA-LR-T2-3: DAL and Saturation Delivery Cost Model) used the correct delivery cost of 5.213 cents for ECR saturation mail. The rates that I propose are based on my workpapers. not Table 3. Therefore, the use of the older number in Table 3 **does** not affect either **of** the rate proposals presented in my testimony.

4

1   CH IRM N OMAS: This brings us to oral

2   cross-examination. One participant has requested oral

3   cross, the United States Postal Service. Mr. Hollies?

4   MR. HOLLIES: The Postal Service has **also**

5   indicated to counsel that it does not, in fact, have

6   questions this morning for this witness.

7   CHAIRMAN OMAS: Is there any additional

8   follow-up, cross-examination for Witness Ingraham?

9   (No response.)

10   CHAIRMAN OMAS: Are there any questions from

11   the bench?

12   (No response.)

13   CHAIRMAN OMAS: Mr. Ingraham, since there

14   seem to be no questions, that completes your

15   appearance here today and your testimony. We do

16   appreciate your contribution to our record, and you

17   are now excused. Thank you.

18   (Witness excused.)

19   CHAIRMAN OMAS: Mr. Horwood, would you

20   please introduce your next witness?

21   MR. HORWOOD: Mr. Chairman, my next witness,

22   Professor Kelejian, is not here yet. We told him to

23   come about 10 o'clock since we were expecting

24   witnesses ahead of him, so if we could perhaps take a

25   short recess.

1   CHAIRMAN OMAS: Well, I will say one thing.

2   I don't think that you can ever take into

3   consideration that there is going to be cross-

4   examination or tell your witness. The hearings start

5   at nine-thirty, and it is appropriate for them to be

6   in the hearing room when we begin. So I don't think

7   that, in the future, you should take it upon yourself

8   to make that determination.

9   We'll take a 10-minute recess and come back

10   at 10 o'clock.

11   MR. HORWOOD: Thank you.

12   (Whereupon. a short recess was taken.)

13   CHAIRMAN OMAS: Mr. Horwood, introduce your

14   witness, please.

15   MR. HORWOOD: Yes. I would like to call

16   Professor Kelejian to the stand.

17   Whereupon,

18   HARRY KELEJIAN

19   having been duly sworn, was called as a

20   witness and was examined and testified as follows:

21   CHAIRMAN OMAS: Please be seated.

22   DIRECT EXAMINATION

23   BY MR. HORWOOD:

24   Q   Professor Kelejian, please state your name

25   and title.

          A   My name is Harry Kelejian, and I'm at the

2   University of Maryland, College Park.

3   Q   Okay. And, Professor Kelejian, you

4   previously submitted a document called "Direct

5   Testimony of Harry Kelejian" on behalf of Greeting

6   Card Association.

7   A   Yes, yes.

8   Q   Do you have any changes or additions to make

9   to that testimony?

10   A   Yes. I have a few updates, which I typed.

11 There are four of them, and I duplicated --

12   CHAIRMAN **O W** : Mr. Kelejian, you don't

13 really have to sit right on top of the mike. If you

14 would just speak in a normal voice, I think it will

15 pick it up.

16   THE WITNESS: Okay.

17   CHAIRMAN **OMAS:** Thank you.

18   THE WITNESS: Yeah. I have four updates. I

19 could read them off quickly, but I also typed them up,

20 so I have a duplicate, one for me and one, I think,

21 counsel has. One of them is that there is a

22 publication I had with my vitae with Dennis Robinson,

23 D. Robinson, and it was in a took entitled -- the name

24 of the book should be titled Advances in Spatial

25 Econometrics Methodology, Tools, and Applications, but

1   on my vi ae here was an o d title, and it was called

2   <u>New Advances in Spatial Econometrics</u>. So I don't know

3   how exciting that is.

4   Then there is another one I have under

5   "Papers Submitted for Publication," there is a paper

6   entitled "Prediction Efficiencies in Spatial Models

7   with Spatial Lags." That was submitted for

8   publication. It has now been accepted for

9   publication.

10   The third thing is, when I first turned in

11   my testimony, upon further reflection, perhaps in

12   response to questions that were given to me, when I

13   first wrote that, I thought there were two marginal

14   effects of using a variable of the form, X to the

15   alpha hat, which I think that notation is clear by now

16   to everyone.

17   Well, it turns out that there is only one

18   marginal issue concerning that, not two marginal

19   effects but one, and this is well described in detail

20   in my response to number 10.

21   And then the final thing is another title

22   change. There is a paper that was published actually

23   in the <u>Journal of Regional Science</u> in **2006,** and it's

24   "**Estimation** Problems in Models with Spatial Weighting

25   Matrices Which Have Blocks of Equal Elements." That's

1   what the title should be called instead of an older

2   title, which was "Important Characteristics of Spatial

3   Models Whose Weighting Matrices Have Blocks of Equal

4   Elements." As a paper gets revised, we sometimes

5   change the title.

6   Anyway, these four things, I have typed and

7   can be turned in. Am I speaking too close again?

8   BY MR. HORWOOD:

9   Q   Thank you, Professor Kelejian. With those

10   modifications, would you adopt as your testimony the

11   testimony as previously submitted?

12   A   Yes, yes.

13   MR. HORWOOD: Okay, Mr. Chairman. I would

14   like to have the testimony entered into the record at

15   this time.

16   CHAIRMAN OMAS: Without objection, and

17   hearing none, I will direct counsel to provide the

18   reporter with two copies of the corrected direct

19   testimony of Henry Kelejian. That testimony is

20   received into evidence. However, as is our practice,

21   it will not be transcribed.

22   (The document referred to was

23   marked for identification as

24   Exhibit No. GCA-T-5 and was

25   received in evidence.)

1   CHAIRMAN OMAS: Dr. Kelejian, have you had

2   an opportunity to examine the packet of designated

3   written cross-examination that was made available to

4   you this morning?

5   THE WITNESS: Yes, yes, yes.

6   CHAIRMAN OMAS: If those questions contained

7   in that packet were posed to you orally today, would

8   they be the same as those provided previously?

9   THE WITNESS: I think they would. I think,

10   since then, I have also thought of -- you know, as one

11   thinks about this, you begin to think of other things

12   you could say. But I think those answers there are

13   good, and I would stand by them. Obviously, the more

14   you think about something, tne more you --

15   CHAIRMAN Oms: Why don't we just think

16   about the questions you've provided? Okay?

17   THE WITNESS: The questions I provided, I

18   think, were good and accurate, to the best of my

19   knowledge.

20   CHAIRMAN OMAS: Thank you.

21   THE WITNESS: Okay. I'm sorry to overdo it.

22   CHAIRMAN OMAS: All right. That's all

23   right.

24   Are there any corrections or additions that

25   you would like to make to those answers that you've

1   provided?

2   THE WITNESS: "Additions" would mean that

3   anything I have thought of since then. Over this

4   weekend, I spent a good amount of time thinking about

5   all of this, and I think one thing I would probably

6   add, if it arose, is, in writing what I did -- in

7   econometrics, sometimes we often think of a marginal

8   effect; that is, a model has this problem, and then we

9   examine the effect of this problem in the absence of

10   all other problems.

11   I thought of each problem that way, and

12   then, over the weekend, I thought, gee, I should have

13   also thought of this effect jointly with this effect,

14   and then I would have given a more --

15   CHAIRMAN O W : Dr. Kelejian, maybe you can

16   discuss that when we get into cross-examination, some

17   of the new thoughts that you had. Would that be okay?

18   THE WITNESS: Yes, yes, it would be.

19   CHAIRMAN **OMAS:** So we'll stand by the

20   written cross-examination that you provided to *us.*

21   Mr. Horwood, would you please provide two

22   copies of the corrected designated written cross-

23   examination of Witness Kelejian to the reporter? That

24   material is received into evidence and is to be

25   transcribed into the record.

1   (The document referred to,

2   previously marked for

3   identification as Exhibit No.

4   GCA-T-5 and was received in

5   evidence.)

6   //

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2006   Docket No. R2006-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF GREETING CARD ASSOCIATION
WITNESS HARRY KELEJIAN
(GCA-T-5)

<u>Interroaatories</u>

Postal Rate Commission   USPS/GCA-1-12 redirected to T5

United States Postal Service   USPSIGCA-1-12 redirected to T5

Respectfully submitted,

Steven W. Williams
Secretary

INTERROGATORY RESPONSES OF
GREETING CARD ASSOCIATION
WITNESS HARRY KELEJIAN (T-5)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designatina Parties
USPSIGCA-1 redirected to T5	PRC, USPS
USPS/GCA-2 redirected to T5	PRC, USPS
`USPS/GCA-3 redirected to T5	PRC. USPS
USPS/GCA-4 redirected to T5	PRC, USPS
USPS/GCA-5 redirected to T5	PRC, USPS
USPS/GCA-6 redirected to T5	PRC. USPS
USPS/GCA-7 redirected to T5	PRC, USPS
USPSIGCA-8 redirected to T5	PRC. USPS
USPSIGCA-9 redirected to T5	PRC. USPS
USPSIGCA-10 redirected to T5	PRC. USPS
USPSIGCA-11 redirected to T5	PRC. USPS
USPSIGCA-I2 redirected to T5	PRC. USPS

**RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5)
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE**

USPS/GCA-1. Please provide a list of all organizations for whom Prof. Kelejian has had occasion to estimate empirical econometric equations. (Within that list, please specifically identify which occasions involved demand analysis and the empirical estimation of price elasticities.) Please provide a description of the econometric techniques which he employed on these occasions.

RESPONSE: My consulting work goes back to the 1970s. I do not remember the details of much of it. As I indicate below, I generally give econometric advice concerning model formulation, estimation, and testing. Some of my consulting work led to academic papers which were published. References are given in my vita.

From my vita it should be clear that I have published a lot of papers, and have consulted for a variety of institutions. Concerning my consulting activities, the institutions that the work I did "most likely" involved, in one way or the other, the estimation of econometric models were

1. W.R. Grace and Company, 1972. This was a long time ago. I really do not remember it except that I did econometrically estimate some equations.

2. Econ. Inc., Princeton NJ, 1973-1975. I worked with D. Bradford of Princeton University for them on value of information problems and its estimation as it relates to remote censoring of crops, such as wheat. Among .other things, we used Bayesian analysis and quadratic dynamic programing. We also estimated demand equations for wheat, and other related things.

3. C&P telephone, Washington DC 1976. Generally I gave econometric advice relating to modeling. I also served as an expert witness in a rate case for them. That case involved the estimation of elasticities and an estimation problem. However, at this point I really do not remember details about it.

4. Arthur Young & Company, 1977-1980. I gave econometric advice concerning modeling and estimation. I do not remember details.

5. The Federal Trade Commission, Washington DC, 1979. I really do not remember the nature of my role with them, nor do I think my work with them involved estimating demand elasticities.

6. AT&T Communications, 1980-1990. My work with them was mostly of a theoretical sort, although we did estimate some models. We worked a good deal on model formulation involving a random parameter approach. I even published a few papers with two of their researchers, namely J. Gatto and S. Stephen. These papers were:

(A) "A Random Coefficient Qualitative Choice Model of the Demand for Telecommunications", (with J. Gatto and S. Stephan), in Economic Letters, Vol. 35, 1991, pp. 45-50.

1

This is a theoretical paper that does not involve an empirical model.

(B) "A Note Concerning Specifications of Interactive Random Coefficient Regression Models", (with J. Gatto and S. Stephan), in Journal of Econometrics, Vol 47, 1991.

This is a theoretical paper that does not involve an empirical model.

(C) "Interstate/InterLata Telecommunication Demand Modelling", (with J. Gatto and S. Stephan), Review of Business, Fall 1989, Vol. 11, No. 2, pp. 25-31. Among other things, in this paper we estimated telecommunication demand models using a random parameter approach in a panel data setting. Essentially, our objective in this study was to asses the feasibility of developing telecommunication demand models on a disaggregated level.

(D)"Stochastic Generalizations of Demand Systems with an Application to Telecommunications", (with J. Gatto and S. Stephan), Information Economics and Policy Vol. 3, 1988, pp. 283-309.

In this paper we considered a stochastic generalization of a system of telecommunications demand equations via a random parameter approach. In this approach there are stochastic generalizations of various restrictions that one might consider in a demand system, such as Slutsky symmetry and a weak separability restriction. The generalization of the Slutsky symmetry condition was in terms moments, rather than as exact restrictions. This paper also contains empirical results.

7. Booz, Allen, and Hamilton, Inc. 1980. I gave econometric advice, but do not remember details.

8. The World Bank, 1982. I mostly gave econometric lectures there arid interacted with some of the researchers on their modeling.

9. Wilkes, Artes, Hendrick, and Lane, 1983. Again, I gsve econometric advice and do not even remember if we estimated models together.

10. Glassman-Oliver 1988-1990, 1994-1995. I *gave* econometric advice concerning modeling and estimation.

11. Association of American Railroads 1991. I really do not remember any details concerning this.

12. D.C. Public Service Commission, 1991-1992. I gave econometric advice, but do not remember details. I also testified on their behalf, but I really do not remember details.

13. InterAmerican Development Bank, 1998-1999. I gave econometric advice and estimated genie coefficient equations. I do not recall details of that work which never came to anything.

14. Interindustry Economic Research Fund, Inc. 2006. I gave econometric advice relating to demand modeling for various medical services. We gathered data and tabulated various descriptive statistics but never got to the formal model estimation.

15. Washington Economic Consulting Group, 2006. The work I am now doing.

16. I am now working with two people at the The Bank of Greece, in Athens Greece, 2006, namely George Tavlas and George Hondroyiannis. My work with them relates to modeling and estimating equations which describe contagion in foreign exchange markets. The econometric approach being taken is spatial econometrics. I have worked with them before on the same topic using the same modeling.

17. As my vita indicates, I worked with the US Army Corps of Engineers from 1989-1999. During that time I mostly worked with a researcher there, namely Dennis Robinson. We published a number of papers together. Looking at my vita,

(A) The paper with D. Robinson and **R.** Vigil (2005) related to characteristics of cities. It did not contain estimated demand equations, but we did estimate a poverty rate equation using spatial econometric techniques.

(B) The paper with D. Robinson (2004) was a theoretical paper.

(C) The paper with D. Robinson (2000) relates to naviyation infrastructure and involved. among other things, the estimation of final demand equations for selected industries. In doing this we used a cubic in time to proxy for a missing variable.

(D) The paper with D. Robinson in (1998) was essentially a theoretical paper suggesting a test. We then illustrated that test in terms of an empirical poverty equation model.

(E) In the paper with D. Robinson (1997) we estimated a production function using spatial modeling techniques. We also considered other techniques, such **as** systems estimation, autocorrelation, and heteroskedasticity

(F) The paper with D. Robinson (1995) was a theoretical paper.

(G) The paper with D. Robinson (1993) was a theoretical paper the results of which were illustrated in terms of a county police expenditure spatial econometric model.

(H) The paper with D. Robinson (1992) was a theoretical paper the results of which were illustrated in terms of a country expenditure model involving spatial correlation.

(I) I also wrote with D. Robinson, Local Public Finance Impact Model: User's Guide and Technical Documentation, IWR Report 94-FIS-10. In this report we used spatial econometric techniques, among other things.

(J) I also did a number of studies for the Army Corps of Engineers relating to vessels, lockage stalls and stall duration, vessel fuel tax system and lock chamber performance and suggestions for maintenance.

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RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5) TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/GCA-2. If any of the following cannot be confirmed, please explain fully. On page **2** of the document originally filed as Appendix C to GCA-T-1, witness Thress's model is described as follows:

$$Ln(V) = a - b(X^\lambda) +$$

The "Box-Cox Model" is described as follows:

$$Ln(V) = a' - b'(\frac{X^\lambda - 1}{\lambda}) + \dots$$

a. Please confirm that the "Box-Cox Model" above could be re-written as follows:

$$Ln(V) = a' + \frac{b'}{\lambda}A^\lambda - \frac{b'}{\lambda} + \dots$$

b. Please confirm that the equation in a. could be re-written as follows:

$$Ln(V) = a + bX^\lambda + \dots$$
$$a = a' - \frac{b'}{\lambda} : \text{and } b = \frac{b'}{\lambda}$$

c. Please confirm that rewriting the equations in this manner shows that the statement on page 2 that "the transformation that Thress used in formulating the internet variable was not the Box-Cox transform" is not correct.

RESPONSE: (a) The Box-Cox model

$$Ln(V) = a' + b'(\frac{X^\lambda - 1}{\lambda}) + \dots \tag{1}$$

can be re-written as you suggest as

$$Ln(V) = a' + \frac{b'}{\lambda}X^\lambda - \frac{b'}{\lambda} + \tag{2}$$

(b) The model in (2) can be re-written as

$$Ln(V) = a + bX^\lambda + \dots \tag{3}$$
$$a = a' - \frac{b'}{\lambda}; \text{and } b = \frac{b'}{\lambda}$$

(c) Given Thress's description of his Box-Cox model on page 37, I assumed that the restrictions in the second line of (3) were not maintaired and the parameters a and b were

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taken without the restrictions

$$a = a' - \frac{b'}{\lambda}; \text{ and } b = \frac{b'}{\lambda}$$

If these restrictions were, in fact, maintained throughour the analysis, which includes re-stricting the estimated parameters, then the models in (1) and (3) can be viewed as equiv-alent. Otherwise they are not the same.

**RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5)
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE**

USPS/GCA-3. Suppose that one believed that the true model for the demand for First-Class single-piece letters was equation (2) hypothesized by Dr. Clifton at line 3 of page 18 of his testimony (GCA-T-1) in this case:

$$\log(Q) = a - b\log(P) + b_2 \log(P_2)$$

Suppose further that the true value of log(P2) was not known.

a. Would it be appropriate in this case to attempt *to* find some variable, call it z, to serve as a proxy for $\log(P_2)$ within equation (2)? If not, why not?

b. Suppose that there was some variable, X, and some constant, y, such that X^y appeared to be very highly correlated with $\log(P_2)$. Would it be appropriate in this case to substitute X^y into equation (2) as a proxy for $\log(P_2)$? If not, why not?

c. If X^y as described in part b. were used instead of $\log(P_2)$ in equation (2). would the estimated value of b be biased? If so, please provide the precise mathematical formulation for the expected value of b expressed as a function of the true value of b?

d. If **X** (not raised to the power y) as described in part b. were used instead of $\log(P_2)$ in equation (2), would the estimated value of b be biased? If so, please provide the precise mathematical formulation for the expected value of b expressed as a function of the true value of b?

RESPONSE:

(a): If the model is

$$\log(Q) = a - b\log(P) + b_2 \log(P_2) \tag{4}$$

and the value of $\log(P_2)$ is not known and the model is estimated in terms of a proxy variable, z, then the results will depend upon the relationship of that proxy and $\log(P_2)$. There are many possibilities of such a relationship. As one example, if

$$\log(P_2) = \gamma_0 + \gamma_1 z + u \tag{5}$$

where u is an error term which is independent of z, then the model in **(4)** expressed in terms of z will be

$$\log(Q) = a - b\log(P) + b_2\gamma_0 + b_2\gamma_1 z + b_2 u \tag{6}$$

This model would probably be re-written and estimated as

$$Log(Q) = A_0 - b\log(P) + A_1 z + e \tag{7}$$
$$A_0 = a + b_2\gamma_0; A_1 = b_2\gamma_1$$

where A_0 and A_1 are parameters to be estimated, and $e = b_2 u$ is an error term. Under typical assumptions, the parameters of (7) which can be estimated are the ones that appear

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in the equation, namely A_0, b, and A_1. Note that

$$\mathbf{Ai} \quad = \quad b_2\gamma_1$$
$$\neq \quad b_2, \text{ unless } \gamma_1 = 1$$

Therefore, unless $\gamma_1 = 1$ there is a problem concerning the estimation of b_2. The estimation of b_2 requires information about γ_1.

On the other hand, suppose if instead of (5), that the relationship between $\log(P_2)$ and z were

$$z = \delta_0 + \delta_1 \log(P_2) + u \tag{8}$$

where u is an error term which is now assumed to be independent of $\log(P_2)$. For future reference note, however, that the error term u would not be independent of z since via (8), z directly depends on u. In this case (8) implies

$$\log(P_2) = \frac{1}{\delta_1}[z - \delta_0 - u]$$

and so the model in **(4)** would become in terms of z

$$Log(Q) \quad = \quad A_0 - b\log(P) + A_1 z + e \tag{9}$$
$$= \quad A_0 + b[-\log(P)] + A_1 z + e$$
$$A_0 \quad = \quad a - b_2\delta_0/\delta_1 \text{ and } A_i = b_2/\delta_1$$

where $e = -\frac{b_2}{\delta_1}u$. Now there are two problems in the estimation of (9). One is that $A_1 \neq b_2$ unless $\delta_1 = 1.0$. The other is that the variable z is correlated with the error term, u and therefore with e. If the focus of attention is on the parameter b, on an intuitive level, the unbiased (more formally consistent) estimation of b has to account for the correlation between z and e. One way to do this is by the instrumental variable technique, an important special case of which is two stage least squares.

(b): Please see the answer to Part (a) above. In other words, X^y could be viewed as z.

The only additional concern I would have here relates to how the constant y is determined. If it is an estimate based on data, then additional problems arise because y would be random as described by its estimated variance.

(c): Please see Parts (a) and (b) above. In the first case described above which lead to equation 7 there would be no bias concerning the estimation of b. Now consider the case as described by (8), which suggests a bias if the correlation between z and u is not accounted for.

2

Let X be the regressor matrix corresponding to equation (9). Let

$$q' = [0, 0, -\frac{b_2}{\delta_1} cov(z, u)]$$

where cov is the covariance between z and u. Let the sample size be T and let Σ be the limit of $T^{-1}X'X$. Let M_2 be the second row of Σ^{-1}. Then, on an intuitive level, the bias, say Bias, in the least squares estimator of b (more formally the inconsistency) would be, under standard assumptions

$$
\begin{aligned}
Bias &= M_2\, q \\
&= M_2 [0, 0, -\frac{b_2}{\delta_1} cov(z, u)]'
\end{aligned}
$$

(d): Please see Parts (a), (b), and **(c).**

RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5) TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPSIGCA-4. On page **4** of the document originally filed as Appendix C to GCA-T-1, Prof. Kelejian challenges witness Thress's assertion that "Holding all other factors constant, the total volume leaving First-class single-piece mail due solely to changes in work-sharing discounts should be exactly equal to the volume entering First-class workshared mail." Specifically, he argues that "the statement relating to these equal **but** opposite volume flows between First-class single-piece mail and First-class workshare mail rests on an assumption that there are no spill-over effects with respect to any other forms of mail!"

a. If "spill-over effects with respect to any other forms of mail" were considered to be one of the "other factors" which witness Thress assumes to be held constant, would witness Thress's assertion be true? If not, why not?

b. Is it believed that witness Thress has failed to properly account for "spill-over effects" between First-class and Standard Mail?

c. If **the** answer to b. is affirmative, please explain the answer, considering that witness Thress explicitly includes the average price difference between First-class workshared letters and Standard Regular mail in his demand equation specification for First-class workshared letters.

d. If the answer to **b.** is negative, is there any practical value to the assertion that "the statement relating to these equal but opposite volume flows between First-class single-piece mail and First-class workshare mail rests on an assumption that there are no spill-over effects with respect to any other forms of mail!"? If so, please explain.

RESPONSE: (a): If one assumes that there are no spill-over effects of any kind, which should include stoppages of mail that are not replaced by other forms of mail, and no new forms of mail that might come into existence, then the equal and opposite assumption might be true. In other words, one is essentially assuming that nothing can change except these two forms of mail and so what goes out "one door" must go in the "other door". I think this is a strong assumption - i.e., it is very restrictive.

(b): My statement was more hypothetical: if there are spill-over effects of any kind, some of which are described in Part (a), then the equal but opposite flow assumption would be violated.

(c): Please see my answers to Parts (a) and (b), especially Part (a). Also, I think that the average price difference between first class workshared letters and standard regular mail does not account for all possibilities concerning spill-overs that might arise. Finally, it should be noted that the nature of my comments on this issue were based on Thress's presentation on page 54 and his equations 11.4, 11.3, arid 11.5. Finally, in my opinion, this is a lesser point given the problems I identified with the econometrics as to how the symmetry condition was imposed.

(d): Please see parts (a) -(c). I still think this is a strong assumption!

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RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5)
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/GCA-5. a. On page 7 of the document originally filed as Appendix C to GCA-T-1, Prof. Kelejian suggests that witness Thress should have replaced the term $[Ln(d_u s)/(V_w s/V_s p)]$ (called "z" by you) with a fitted value i. He goes on to assert that "[i]t should be clear that $\hat{z} \neq [Ln(d_w s)/(V'_w s/V'_s p)]$. Please explain why $[Ln(d_u s)/(V'_u s/V'_s p)]$, as estimated by witness Thress would not represent a satisfactory instrumental variable.

b. Again, on page 7 of the document originally filed as Appendix C to GCA-T-1, Prof. Kelejian states that "[i]f the variable $z = [Ln(d_u s)/(V_u s/V_s p)]$ ... is replaced by a variable such as $[Ln(d_w s)/\hat{w}]$, the resulting parameter estimates will not be consistent, i.e., on an intuitive level, there would be biases."

Please explain precisely why this substitution of $\hat{w}$ within witness Thress's demand equation will produce biased elasticity estimates. Please provide the precise mathematical formulation for the expected values of witness Thress's elasticity estimates relative to their actual values, given witness Thress's use of $[Ln(d_u s)/\hat{w}]$ as an instrumental variable for $[Ln(d_w s)/(V_w s/V_s p)]$ in this case.

c. What is the precise specification which is recommend be used by witness Thress to estimate the elasticity with respect to the average worksharing discount in his First-Class workshared letters equation?

RESPONSE: (a): First, please see the discription of the two stage least squares procedure as given in the literature.' On an intuitive level, let $w_t = (V'_{ws}/V''_{sp})$ and let $\hat{w}_t$ be the predicted value of w_t from the regression on the instruments. Also, let

$$\Delta_{t1} = Ln(dws)/(V'_{ws}/V'_{sp}) - Ln(dws)/\hat{w}_t \tag{10}$$

Finally, let $\hat{z}_t$ be the predicted value of $Ln(dws)/(V'_{ws}/V'_{sp})$ from a regression on the instruments, and let

$$\Delta_{t2} = Ln(dws)/(V'_{ws}/V'_{sp}) - \hat{z}_t \tag{11}$$

Then, if the instruments that were used include all the predetermined variables in the equation being considered, as well as the ones indicated by Thress, Δ_{t2} will be orthogonal to all of the predetermined variables appearing in the model because they were all used as part of the instruments. Please see the above indicaled references; this orthogonality is a condition for consistency. This would correspond lo the use of $\hat{z}_t$. On the other hand, because of the nonlinearity involved in (10), Δ_{t1} will not be orthogonal to all of

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'A good reference for models that contain non-linearities is T. Amemniya, Avanced Econometrics, Harvard University Press, Cambridge, Mass. 1985. See especially chapter 8. A simpler presentation of some of this material is given in H. Kelejian and W. Oates, Introduction to Econometrics, Principles and Applications, (3rd edition), Harper and Row Publishers, 1989. Concerning this, see chapters 7, which relates *to* linear models, and *8* which relates to nonlinear models. Concerning the selection of instruments please see pp. 277-280.

the predetermined variables appearing in the model even if they were all used which I do not think they were because Thress describes his procedure on page 55 in terms of three instruments, namely a dummy variable, a time trend,. and its square. Actually, another issue is that Thress indicates that he replaced the ratio which appears in the model, namely V_{ws}/V_{sp} by the calculated value of $Ln(V'_{ws}/V'_{sp})$. I really do not know why he did this because the ratio that appears in the model is not in log terms.

(b): Please see Part (a). On an intuitive level, there would be biases. More formally. let X be the regressor matrix corresponding to the use of $Ln(d_{ws}/\hat{w})$. Let β be the vector of parameters appearing in the model, and let the estimator of β be $\hat{\beta}$. Again, let the sample size be T, and let Σ be the (probability) limit of $T^{-1}X'X$. Finally, let Δ, be the $T \times 1$ vector of values of A,, corresponding to the use of $Ln(d_{ws}/\hat{w})$. Then, under typical assumptions, the bias (more formally the inconsistency) of each of the elements of the vector $\hat{\beta}$ is

$$\Sigma^{-1}[p \lim T^{-1} X' \Delta_1] \tag{12}$$

The expression in (12) would be zero if $\hat{z}_t$ were used and were based on the three instruments Thress used, as well as all predetermined variables appearing in the model. The reason for this is that $X'\Delta_2 = 0$ because of their orthogonality.

(c): I can not answer this question because I have not studied this market. nor do I know all the details which I would need to know in order to give a proper answer.

RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5)
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/GCA-6. At the bottom of page 7 of the document originally filed as Appendix C to GCA-T-1, Prof. Kelejian states that witness Thress "implicitly assumed that the error terms in the First Class single piece and worksharing equations are uncorrelated." At the top of page 8 of that document, he suggests that this assumption "may not be reasonable."

a. Is there any specific basis for questioning the reasonableness of this assumption? Please provide all mathematical or statistical evidence that was used to form this basis.

b. Please confirm that the correlation between the regression residuals for First-class single-piece letters and First-class workshared letters calculated by witness Thress in this case, which are presented in Library Reference LR-L-64, sponsored by witness Thress, is equal to -0.056 over the sample period for which both sets of residuals exist.

c. In general, would two variables which exhibit a correlation of -0.056 be considered to be "uncorrelated? If not, why not.

RESPONSE: (a): The assumption I am referring to is the lack of correlation between the two equations. If the two equations have correlated disturbance terms, then the prior information used to estimate the first class single piece mail will not be independent of the disturbance term in that equation. In other words, I think one should consider the possibility that there is a correlation. If there is one, then the development in the referred-to book by Judge et al. on pages 57-59 will indicate that there should be a covariance term in the matrix equation (3.2.20b) in that book by Judge et al. on page 58. Actually, on page 58 Judge et al. explicitly assume that the prior information is independent of the model's disturbance term.

(b): I was not aware of this estimated correlation. However, if that estimated correlation is in terms of estimated residuals which are obtained from procedures which are subject to question, then the estimated correlation is also subject to question. For example, if the estimated residuals from the single piece equation are obtained after the symmetry conditions are imposed as was indicated by Thress, then I would interpret that estimated correlation with suspicion and likely subject to bias.

(c): In practice, given typical sample sizes, etc. I would assume that two variables are uncorrelated if their "properly estimated" correlation is -0.056. However, please see Part (b).

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RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5) TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/GCA-7. On page 9 in the document originally filed as Appendix C to GCA-T-1, Prof. Kelejian states that "model selection via a minimization of a mean squared error could very well lead to an incorrect model."

a. He cites, as one example of how a mean-squared error criterion could "lead to incorrect results", "the case in which the various models considered have different numbers of parameters." Please explain why a mean-squared error criterion could lead to incorrect results when comparing two equations with different numbers of parameters.

b. He cites, as another example of how a mean-squared error criterion could "lead to incorrect results", "the case in which a variety of complicated estimation procedures are considered." **(i)** What specific "complicated estimation procedures" are you referring to with respect to witness Thress's First-class single-piece letters equation? (ii) Please explain why a mean-squared error criterion could lead to incorrect results when comparing two equations which are estimated using "complicated estimation procedures."

c. In discussing alternatives to a mean-squared error selection criterion, William Greene. in the third edition of his Econometric Analysis (1997), says the following on **401** : "Although intuitively appealing, these measures are a bit unorthodox in that they have no firm basis in theory."

In the document originally filed as Appendix C to GCA-T-1, at page 1, Prof. Kelejian criticizes witness Thress because "some rather intuitive procedures were used that have no formal basis. This lack of a formal basis is important and not just a concern raised by an 'ivory-tower' academic."

Please confirm, therefore, that the "lack of a formal basis" for these alternative model selection criteria is a serious problem, and that Prof. Kelejian's statement argues strongly in support of a mean-squared error selection criterion, since the mean-squared error selection criterion has a "firm basis in theory". If not confirmed, please explain.

RESPONSE:

(a): Assume two models are to be compared and they have a different number of parameters. In my letter I had assumed that the mean square error relates to the model's dependent variable. That is, it is a residual sum of squares divided by something. My discussion below is based on this assumption.

As an illustration of "problems", in general if the model is estimated by least squares, the more parameters there are the smaller will be the residual sum of squares. In and of itself, this implies that one can not compare two models based only upon the residual sum of squares because the model with the most parameters will always "win". It would follow that if models are to be compared in terms of the residual sum of squares, there must be some penalty factor that will discount that sum of squares for the number of parameters which are used.[2] The mean square error can be calculated in a variety of ways. If it is

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[2] As an illustration, see pages 159-160 in W. Greene, Econometric Analysis, 5th ed., Prentice Hall, Upper Saddle River, New Jersey, 2003.

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just the sum of squared residuals divided by the sample size then it would not be useful because, again, the model with the most parameters wculd "win". A better calculation **of** the mean square error would be the residual sum of squares divided by the sample size minus the number of parameters contained in the model. In this case a given value of the residual sum of squares will lead to a larger value of the mean square error because the denominator would be smaller if a larger number of parameters are used.

I do not know which form of the mean square error Thress used. However, in a model such as his subject to the problems associated with his implementation of the Box-Cox formulation, his imposition of the symmetry condition, and his procedure for accounting for autocorrelation, I would have no idea as to what an appropriate penalty factor would be that would lead to a correct model selection.

(b): Please see Part (a). I am referring to the imposition of the Box-Cox formulation. the symmetry conditions, and the procedure for accounting for autocorrelation.

As a simple example that the mean square error might lead to an incorrect model consider a fairly minor complication of heteroskedasticity. This is not one of the complications I raised, nor is it one of the problems that Thress faced; I am using it for illustrative purposes only because of its simplicity.

Consider the two models

$$Model\ 1\ :\ y = X\beta + u;\ u \sim (0, \sigma^2 I) \tag{13}$$
$$Model\ 2\ :\ y = X\beta + u;\ u \sim (0, \Omega)$$

Suppose Model 2 is the true model in the sense that it describes how the dependent variable y is generated. For ease of exposition, suppose Ω is known. In this case the researcher would estimate Model 1 by least squares and obtain the residual sum of squares, say RSS_{OLS}. The researcher would estimate Model 2 by generalized least squares and obtain the residual sum of squares, say RSS_{GLS}. By construction, the least squares procedure minimizes the residual sum of squares and so $RSS_{OLS} < RSS_{GSL}$. Since both models have the same number of parameters, and since the least squares procedure, by construction, minimizes the residual sum of squares, Model 1 would be selected even though Model 2 is the true model.

(c): Please see Part (b). Furthermore, in looking through the specification analysis and model selection Chapter 8 in the newer 5th edition by **W.** Greene, Econometric Analysis, 5th ed., Prentice Hall, Upper Saddle River, New Jersey, 2003 what I see is a reasoned evaluation of many procedures. I do not see a blanket statement that the various measures discussed in that chapter are unorthodox and have no firm basis in theory. I also do not

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see a statement which indicates that the mean squared error has a firm foundation in theory and can be applied to models which have various complications. let alone models like Thress's which contain improper procedures.

I can think of 3 procedures which I would view as formal.

1. The Bayesian posterior odds approach: in this framework one starts off with a prior probability that each considered model is the true one. One then considers the dala and after going through certain manipulations, arrives at the posterior odds that each model is the true one. One would then select a particular model as the true one as the one which has the largest posterior odds.

2. A test involving the nesting of **2** models: In this framework one would consider two models. The one which the researcher believes to be most likely the true model is viewed as the null hypothesis.. The other model is viewed as the alternative. Say the variables which appear in the alternative model which do not appear in the null hypothesis model are Z. Then one adds Z to the null hypothesis model and estimates that expanded model. One then tests for the joint significance of Z. The null model is accepted as the true model if Z is not jointly significant. If Z is jointly significant, I would stop my testing procedure and go back to the drawing board to reconsider my theory. I would view this as having a formal basis in the sense that it is based on a formal testing procedure.

3. The J test: This procedure is somewhat related to the one in 2 above. Here one tests to see if the alternative model has any explanatory power, or more formally, any significance after the null model is considered. I would view this as having a formal basis in the sense that it is based on a formal testing procedure.

3

**RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5)
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE**

USPSIGCA-8. On page 9 of the document originally filed as Appendix C to GCA-T-1, Prof. Kelejian states that, in order for a model selection procedure to be valid "the complete set of models that are being considered must include the correct model." Please confirm that, as a practical matter, it is never possible to know the "correct model" in any empirical econometric work. If not confirmed. please explain fully.

RESPONSE:

In a sense, my statement was an obvious statement. It simply states that the true model can not be selected if it is not even considered. Also, formal statistic tests are based on modeling assumptions. These assumptions typically relate to a true model, which is the model which generates the dependent variable. In economics we often deal with complicated issues, as well as uncertainty. In practice, I think one can not be sure of anything.

RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5)
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/GCA-9. Based on the selection criteria of his choosing, which of the First-class single-piece letters models presented by witness Thress in LR-L-65 would Prof. Kelejian choose? If the choice is different from the model used by witness Thress in this case, please explain the basis for the choice and describe the ways in which the chosen model is superior to the model used by witness Thress.

RESPONSE:

As I indicated, I focused on the econometric procedures rather than on the actual empirical estimations, and so I can not pick out one of the equations as the "best one". What I can say, however, is that I would have approached the model formulation and estimation differently. For example, I would have tried hard to come to a model which, in some sense, was based on whatever economic theory I had access to. I would have viewed that model as my null hypothesis. If I felt that there are parameter restrictions across equations I would have tried to estimate those equations jointly as a system. If I believed in the symmetry restrictions assumed by Thress I would not have gone through the substitutions he did. I would also have tried to estimate all parameters of the model jointly.

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RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5) TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPSIGCA-10. Dr. Harry Kelejian, in the document originally filed as Appendix C to GCA-T-I, says the following with respect to witness Thress's estimate of the Box-Cox coefficient, A.

> "The implication of this statement is that λ was first estimated in a prelimi-
> nary step which was which was prior to full model estimation which, I assume,
> would incorporate his stochastic symmetry conditions, etc. Now this may seem
> to be a very intuitive thing to do, but on a formal level problems are raised. For
> example, suppose the estimated value of λ is A'. This statement then suggests
> that the internet variable that was used in the full estimation of the model was
> $X^{\lambda'}$. If this is true, problems arise! Actually, one's intuition may lead one to
> think that problems should not arise if λ is properly estimated in that prelim-
> inary step. Unfortunately this is not the case. That is, even if A is properly
> estimated in a preliminary step, the explanatory variable $X^{\lambda'}$ is not an ordinary
> explanatory variable because it is based on an estimated coefficient and there-
> fore has a random component. This random component should be obvious
> since Thress himself on page 37 gives t-ratios relating to it! If an explanatory
> variable has such a random component that randomness can not be ignored in
> the model's estimation, nor can it be ignored in the inferences that come from
> that model! Assuming there are no other problems with the model, all of this
> suggests that the estimation of λ must be done in the final model considered
> which should incorporate all the other parameter restrictions that are consid-
> ered. On a somewhat intuitive level, problems arise because the randomness
> in such a model would not only come from the model's error terms, but also
> from the explanatory variable, $X^{\lambda'}$."

> What are the specific problems to which Dr. Kelejian refers here? Will
> the inclusion of $X^{\lambda'}$ directly in the model estimated by witness Thress bias
> the estimated values of the other coefficients in witness Thress's model (e.g.,
> the estimated own-price elasticity)? Please provide citations to econometrics
> literature in support of the answer.

RESPONSE:

Typically, econometricians study the consequences of a particular problem in the ab-
sence of other problems. This sort of analysis indicates marginal effects of the particular
problem being considered. When I wrote my letter, which has since become direct tes-
timony, I thought that there were two important marginal effects relating to the use of a
variable such as $X^{\hat{\lambda}}$ as an ordinary regressor. One of these, I thought, was an inconsis-
tency (intuitively, a bias) relating to the estimates of the model parameters. Upon further
thought this is not the case. As my demonstration below indicates, under typical con-
ditions an inconsistency would not be one of the marginal effects. The other marginal

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effect, however, is that the estimated standard errors relating to the model parameter estimates would be incorrect unless the random nature of X^{λ} was explicitly considered. As my demonstration below will indicate this is a marginal effect. The importance of this. for example, is that one may think that a variable is significant, when it is not. **My** reasoning is described in detail below. On an intuitive level, and excluding systems issues, typically calculated standard errors (or t-ratios) are based on the assumption that the only random component in the model is the error term. However, if an explanatory variable is of the form $X^{\hat{\lambda}}$, then there are two random components to the model and so standard errors which do not account for both will be incorrect.

Please see pages 127-135 in T. Amemeiya, Advanced Econometrics, Harvard University Press, Cambridge, Massachusetts, 1985. These pages describe nonlinear least squares estimation of the model parameters and its properties. The presentation is such that there may be nonlinearities with respect to all the parameters, or just one. See also pages 368-370 in that book. These pages give results relating to a model in which the regressor is based on an estimated parameter. The results given clearly demonstrate that the variances of the estimators of the model parameters reflect the random nature of such a regressor. I am giving my direct demonstration below because I think it is much simpler. Another reference relating to nonlinear estimation is chapter 9 in **W.** Greene, Econometric Analysis, 5th ed., Prentice Hall, Upper Saddle River, New Jersey, 2003.

My Direct Demonstration

Suppose the model is

$$y_t = Z_t\gamma + bX_t^{\lambda} + \varepsilon_t \tag{14}$$

where γ, b, and λ are parameters, and Z_t is a vector of observations on explanatory variables, X_t is an explanatory variable, and ε_t is the disturbance term. Let T be the sample size. Suppose we have a consistent estimator of λ, say $\hat{\lambda}$. This means that as the sample size increases beyond limit (goes to infinity). the probability that $\hat{\lambda}$ and λ will differ by any amount, however small, goes to zero. To continue, suppose $\hat{\lambda}$ is based on data which are independent of the disturbance term in (1**4**). [3]

Consider the variable $X_t^{\hat{\lambda}}$. Using the mean value theorem to expand about λ, we can express $X_t^{\hat{\lambda}}$ as

$$X_t^{\hat{\lambda}} = X_t^{\lambda} + X_t^{\tilde{\lambda}}\log(X_t)[\hat{\lambda} - \lambda] \tag{15}$$

where $\tilde{\lambda}$ is between $\hat{\lambda}$ and λ. Intuitively, since $\hat{\lambda}$ goes to λ, as the sample size goes to infinity, and $\tilde{\lambda}$ is between $\hat{\lambda}$ and λ, then $\tilde{\lambda}$ also goes to λ. Somewhat more formally, as the

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[3]This **independence assumption is a simplification. In the** model **considered by Thress this independence condition would not hold because** $\hat{\lambda}$ **would be based on the same data.**

2

sample size increases beyond limit, the probability that $\dot{\lambda}$ will differ from X by any amount limits to zero.

Substituting (15) into **(14)** yields a model in which the variable being explained, y_t, is related to X_t^{λ}, namely

$$y_t = Z_t\gamma + bX_t^{\lambda} + bX_t^{\lambda}\log(X_t)[\hat{\lambda} - \lambda] + \varepsilon_t \tag{16}$$

The explanatory variables in **(16)** are Z_t and X_t^{λ}. Let the T observations on Z_t and X_t^{λ} be given by the matrix H, and let the corresponding coefficient vector be

$$\beta' = (\gamma'. b)$$

Finally, let the T values of $bX_t^{\lambda}\log(X_t)$ be given by the vector V. Then, the matrix form of (16) is

$$y = H\beta + V [\hat{\lambda} - \lambda] + E \tag{17}$$

where ε is the vector of disturbance terms.

The least squares estimator of β based on (17), which takes X_t^{λ} as one of the explanatory variables is

$$\hat{\beta} = (H'H)^{-1}H'y \tag{18}$$

Replacing y by its expression in (17) yields

$$\hat{\beta} = \beta + (H'H)^{-1}H'V [\lambda - \lambda] + \tag{19}$$
$$(H'H)^{-1}H'\varepsilon$$

which can easily be expressed as

$$T^{1/2}[\hat{\beta} - \beta] = [T(H'H)^{-1}] [T^{-1}H'V] T^{1/2}[\hat{\lambda} - \lambda] + [T(H'H)^{-1}] T^{-1/2}H'\varepsilon \tag{20}$$

As the sample size T increases beyond limit, typical modeling assumptions would imply

3

limits of the sort:[4]

$$[T(H'H)^{-1}] \rightarrow \Sigma_{HH}^{-1} \qquad (21)$$

$$[T^{-1}H'V] \rightarrow \Sigma_{HV}$$

$$T^{1/2}[\hat{\lambda} - \lambda] \rightarrow N(0, \alpha^2)$$

$$T^{-1/2}H'\varepsilon \rightarrow N(0, \sigma_\varepsilon^2 \Sigma_{HH})$$

where

$$\Sigma_{HH}^{-1} \text{ is a finite matrix}$$

$$\Sigma_{HV} \text{ is a finite vector}$$

and where $N(0, \alpha^2)$ is the normal with mean zero, and variance α^2, and $N(0, \sigma_\varepsilon^2 \Sigma_{HH})$ is the multivariate normal with mean zero and variance-covariance matrix $\sigma_\varepsilon^2 \Sigma_{HH}$).

The implication of (20) and (21) is that the limiting distribution of $T^{1/2}[\hat{\beta} - \beta]$ is

$$T_{1/2}[\hat{\beta} - \beta] \;\; \blacksquare \;\; N(0, \Omega_1 + \Omega_2) \qquad (22)$$

where

$$\Omega_1 = \alpha^2 \Sigma_{HH}^{-1} \Sigma_{HV} \Sigma_{HV}' \Sigma_{HH}^{-1}$$

$$\Omega_2 = \sigma_\varepsilon^2 \Sigma_{HH}^{-1}$$

In light of **(22)** one would base small (e.g , finite) sample inferences on the approximation

$$\hat{\beta} \sim N(\beta, T^{-1}[\Omega_1 + \Omega_2]) \qquad (23)$$

Notice that if $\hat{\lambda} = \lambda$, then $\alpha^2 = 0$ and the normal distribution in (23) would reduce to

$$\hat{\beta} \sim N(\beta, T^{-1}\Omega_2) \qquad (24)$$

If the researcher ignores the randomness in an explanatory variable such as $X_t^{\hat{\lambda}}$, then inferences that would be made using standard computer results would correspond to an empirical version of (24).

Two points should be noted about these results. First, since the distribution in (22) has a zero mean vector, the estimator $\hat{\beta}$ of β would not be inconsistent. Again, on an

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[4]In obtaining (21) **one** should note Theorem 4.1.4 on page 112 in the **book** by T. Amemiya, Advanced Econometric, Harvard University Press, Cambridge Massachusetts, 1985.

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intuitive level, this means there would not be a bias. On the other hand, since the variance covariance matrix in (23) is larger than the one in **(24)** (larger means that the difference is positive semidefinite), the t-ratios based on an empirical version of (24) will be overstated and so one might be lead to think that a particular variable is significant when in fact it is not.

RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-T5)
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE

USPS/GCA-11. At page 9 in the document originally filed as Appendix C to GCA-T-1, Prof. Kelejian indicates an understanding that "Thress indicates that he tested for autocorrelation via the model which is his equation 111.12"

a. In his testimony, on page 321, at lines 1 - **4,** witness Thress describes the procedure whereby he tests for the presence of autocorrelation as follows:

The exact nature of the autoregressive process is identified by testing the significance of the partial autocorrelation of the residuals at one, two, and four lags. In general, a 95 percent confidence level is used to test for the presence of autocorrelation.

Is the methodology described by witness Thress in tne above quote, testing the significance of the partial autocorrelation of the residuals, an appropriate method of testing for the presence of autocorrelation? If not, why not?

b. At page 9 in the document originally filed as Appendix C to GCA-T-1, Prof. Kelejian states that "since the parameter λ in Thress's version of the Box-Cox procedure was estimated prior to the full estimation of his model, and given the errors in the way he imposed the stochastic symmetry conditions, it is difficult to deduce just how to make proper inferences in terms of a model such as 111.12"

If the Box-Cox coefficient, λ, and the stochastic symmetry condition were introduced as you have suggested they should have been by witness Thress, would there be any objection to the procedure which he used to test for and correct autocorrelation? Is so, please explain.

RESPONSE:

(a): First, I still do not see why the third quarter lag was not considered. It still seems confusing to me that one would consider one, two, and four quarter lags without also considering the third quarter lag. Ignoring this issue, I would find it difficult to determine the properties of the "seemingly reasonable" procedure used by Thress because of the other procedures he used, namely his version of the Box-Cox procedure, his imposition of the symmetry condition, and his model selection procedure. I have stated problems with respect to all of these procedures. The properties of the tests used by Thress are difficult to determine because, I assume, the residuals were obtained after these complex procedures were used. If they were obtained before these procedures were used, I would find that very difficult to understand because a researcher would typically look for autocorrelation as somewhat of a residual after his model contains all the available infcrmation.

(b): My objections would diminish, but not to zero. The reason for this is that I think the third quarter lag should also have been considered. Second, I might have accounted for an assumed pattern of autocorrelation by incorporating it directly into the model and estimating its parameters along with the other model parameters.

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**RESPONSES OF GREETING CARD ASSOCIATION WITNESS KELEJIAN (GCA-TS)
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE**

USPSIGCA-12. Please provide copies of a Statement of Work, or any other documents or correspondence containing instructions or directions defining the nature and scope of the task(s) that Prof. Kelejian was asked to perform in the preparation of the document which became the declaration originally attached to GCA-T-1 **as** Appendix C.

RESPONSE:

See attached documents.

From: James Clifton [clifton@wecg.com]
Sent: Wednesday, August 16,2006 2:43 PM
To: 'Harry Kelejian'
Subject: Question

Harry:

Re: our discussion on Monday on just the critique of Thress. would you be willing to stand by those points by pulting them in a typed letter under your signature for possible use as an Appendix?
Although I know from having used your intro McGraw Hill text that you write well or Oates does or McGraw Hill editors do, or all of the above, we would probably want to take a crack at editing a draft of it. By 'we' I mean the attorneys mostly.

Ball-park cost is the second hurdle if you are amenable lo this.

Regards,

Jim

P. S. Promise stronger. better coffee next time.

From: James Clifton [clifton@v
Sent: y August 1S 2006 11:05 AM
To:) le
Subject: RE' Question

That is fine, Harry. Please just advise me if we are getting close to that $4.200 cap. If we are getting close you should know by that time more precisely whether: (a) you will be within that cap; and (b) if beyond the cap, how much more time you will need, etc.

Time is of the essence in getting a complete draft letter from you as the final must be submitted September 6th. but really needs to be complete for reproduction and related production reasons by Friday, September 1st. So, if we can get the draft by next week, that would be great.

Jim

-----Original Message—
From: Harry Kelejian [mailto:kelejian@econ.bsos.umd.edu]
Sent: Friday, August 18, 2006 10:04 AM
To: clifton@wecg.com
Subject: RE: Question

James, concerning the ball park figure: I had a good talk with Reza yesterday. He said there were about 40 pages in the Thress testimony that I did not read but I should. I arrived at a ball park figure of $4200. This figure was constructed as follows. $175 per hour times:
Roughly

4 hours for carefully reading those 40 pages
4 hours for "getting into the writing mode
4 hours for each of the following 3 procedures :Autocorrelation, Box-Cox, and the symmetry condlions. The MSE procedure related to the Shiller procedure and so there is no reason to go over that. Also, a good discussion of that would take more time.
4 hours for iterations on comments I may receive from your lawyers.
The actual bill I send to you will relate to the hours I actually put in. That bill may be less than $4200 less

1   CHAIRMAN OMAS: This brings us to oral

2   cross-examination. Two participants have requested

3   oral cross-examination. The Alliance of Nonprofit

4   Mailers, Mr. Levy; and the United States Postal

5   Service, Mr. Koetting.

6   Are there any other participants here in the

7   hearing room this morning who wish to cross-examine

8   Witness Kelejian?

9   (No response.)

10   CHAIRMAN **OMAS:** There being none, Mr. Levy

11   does not seem to be here. So I guess it's up to you.

12   Mr. Koetting.

13   MR. KOETTING: Thank you, Mr. Chairman.

14   Before I begin my cross-examination, Mr. Chairman, I

15   believe it's probably appropriate for me to make a few

16   comments about the presiding officer's Ruling No.

17   **R2006-1/95** that was issued this morning regarding the

18   *GCA* request for a protective order.

19   What I have to report is, unfortunately,

20   last week, very shortly after Mr. Levy made his copies

21   of that material, he did, at my request, furnish a

22   copy of that material to me, and I've subsequently

23   distributed copies of that to our expert witnesses in

24   Chicago and to our personnel at the headquarters

25   building.

1   I don't know that that necessarily changes

2   the landscape entirely in the sense that the

3   distribution is limited to a fairly finite number of

4   individuals, and, in compliance with the spirit of the

5   protective order, we certainly will not be

6   disseminating that material any further.

7   But, on the other hand, I felt it important

8   to make all of the parties aware that that cow is out

9   of the barn, so to speak, and that material is --

10   there are copies of that out there beyond what Mr.

11   Levy has, so it's a little different than what was, I

12   think, contemplated in the order.

13   CHAIRMAN **OMAS:** In the order. Mr. Horwood?

14   MR. HORWOOD: That sounds reasonable to me,

15   I think, as long as those who have gotten copies of it

16   would execute the certification if the order is

17   ultimately granted, we certainly would not have

18   objection to the Postal Service witnesses, other

19   personnel reviewing this material for purposes of this

20   case.

21   CHAIRMAN **OMAS:** Thank you, Mr. Horwood.

22   THE WITNESS: Can I say something?

23   Actually, I gave the material to counsel, who then

24   gave it there, just to be accurate. I never sent it

25   to him directly.

1   CHAIRMAN OMAS: Okay.

2   THE WITNESS: I don't know if that makes a

3   difference.

4   CHAIRMAN OMAS: 'There is no problem, sir.

5   It seems that it's all worked out, and all parties

6   involved are happy.

7   Mr. Koetting, you may proceed.

a   MR, KOETTING: Well, before we leave that, I

9   do have one request perhaps for some clarification

10   from Mr. Horwood.

11   My impression from reading the motion was

12   that the primary focus of concern with Dr. Clifton was

13   it did not encompass the entire body of materials but

14   was focused primarily on a repsrt, I believe, from

15   March.

16   There were other materials in the set that

17   related to what Professor Kelejian had been looking

18   at, and I'm not sure exactly -- I don't think we're

19   going to touch on it necessarily all that much in the

20   cross-examination, but I wanted to make sure, before I

21   start my cross-examination, that if I don't refer to

22   the specifics of the report, that was the primary

23   focus of the concern.

24   MR, HORWOOD: That was the primary focus,

25   but the motion did go to all of the material that -- I

1 guess, if I perceive a problem, if you're asking a

2 question, I will alert the Commission and then raise

3 an objection.

4   MR. KOETTING: I'm bard pressed to believe

5 that anything I had in mind would be divulging

6 anything, but I think the procedure you've suggested

7 should work fine.

8   Thank you, Mr. Chairman.

9   CHAIRMAN OMAS: You may proceed, Mr.

10 Koetting.

11   CROSS-EXAMINATION

12   BY MR. KOETTING:

13   Q   Professor Kelejian, could you please refer

14 to your response -- I'm sorry. Let me introduce

15 myself. My name is Eric Koetting, and I will be

16 asking you questions this morning on behalf of the

17 Postal Service.

18   A   Okay.

19   Q   If you could please refer to your response

20 to our Question 7(a).

21   A   7(a). Wait a minute. Okay. What is the

22 question, without me reading the whole thing right

23 now?

24   Q   Right. The first step is for you to get

25 there.

1   A   I have my response in front of me.

2   Q   Good. Thank you. In the ··

3   A   I'm sorry. Okay. Go ahead. I'm sorry.

4   Q   Fine. Take your time. In the middle

5 paragraph of that response, you indicated that the

6 best calculation of mean-squared error, if it is to be

7 used as a selection criterion, is "the residual sum of

8 squares divided by the sample size minus the number of

9 parameters contained in the model." Do you see that

10 part of your response?

11   A   I see the word "a better calculation," not

12 "best"; "a better calculation." That's better because

13 it's discounting for the number of parameters. I

14 don't know what is best for this purpose.

15   Q   Fine. Thank you for that clarification.

16   At the top of the very next paragraph, in

17 response, you also indicate that you "do not know

18 which form of the mean-square error Tress used." Do

19 you see that part of your response?

20   A   Yes, I do.

21   Q   I take it, then, that you were not aware

22 that Mr. Tress defines "means-square error" as he uses

23 that term on page 35 of his testimony, lines eight

24 through nine, as "the sum of squared residuals divided

25 by degrees of freedom."

1   A   Okay. I didn't know that, but I know what

2   that means, yes.

3   Q   And you, likewise, were not aware that he

4   repeated that definition in his Library Reference 65

5   and in his response to GAC Interrogatory No. 10 or

6   that he shows that calculation explicitly in his

7   Library Reference **64** on page 280. You didn't look at

8   any of those materials.

9   **A**   No, I didn't. I accept that what you said

10   was he got the residual sum squares and divided by

11   degrees of freedom, which, typically taken, would be

12   the sample size minus the number of parameters. In my

13   testimony, I said, This is a better calculation than

14   just dividing by samples.

15   Q   So based on that definition, you would agree

16   that his utilization matches what you were describing

17   as the better definition. Correct?

18   **A**   Better relative to something else which is

19   bad. That doesn't mean "best." I mean, if you're

20   going to grant me, on the means-squared error, there

21   are a number of problems that i raised, and one of

22   them, the most serious to me, would be that if I don't

23   believe in the way the model was estimated in the

24   first place, then the residuals are not accurately

25   estimated. So when you get residuals, some are

1   squares, I don't know. That's the result of a bunch

2   of complicated procedures. I don't know how to

3   interpret that. So I'm just staying with that

4   statement.

5   If I could elaborate just a little more

6   because I think this may be important, may I? I don't

7   know. Am I allowed to elaborate? Well, go ahead.

8   Maybe you should ask the next question.

9   Q   Let me follow up a little bit on what you

10 just said with the concept that, if you're looking at

11 the residuals and trying to fathom something from that

12 as to how well your model is performing, the residuals

13 are sort of a function of how the model works, what's

14 in the model. But wouldn't that same limitation apply

15 to the three procedures that yo; specified on the

16 third page of your response **as** well?

17   **A**   I'm sorry. I forgot to bring a pencil with

18 me, in the rush, or a pen. In response to some

19 questions, I may want to jot something down, and the

20 only thing here -- I am truly sorry. Thank you.

21   Can you please ask ycur question again?

22   Q   Sure. You were suggesting that the

23 procedure, examining and comparing the means-squared

24 errors, and if I mischaracterize what you said, you

25 can certainly correct me, is limited by the fact that

1   the residuals and the structure of the residuals is

2   going to be dependent on what's in the model and how

3   good the model is or isn't that you're working with.

4   My question is, on the last page of your

5   response to our Question No. 7, you talk about three

6   procedures which you view as formal in terms of the

7   model selection. Wouldn't that same limitation apply

8   to those as well, in terms of how you are comparing

9   what comes out of the model?

10   **A**   No. I think the residual sum of squares is

11   a different animal, and it's formulated in a different

12   way than these specification tests like the J test or

13   the artificial nesting test or the Bayesian posterior

14   distribution-type test, the posterior inflammation

15   odds. Those are different sorts of things.

16   The mean-squared error is basically that

17   you're dividing by degrees of freedom instead of

18   sample size. That's better than sample size, but it's

19   still based on estimated residuals, and posterior

20   information criterion isn't based on that, and I'm

21   just getting nervous now, but the mean-squared error,

22   in a sense, if you have a model that I think is not

23   specified properly, if you select a model based on

24   mean-squared-error-type criterion, you're sort of

25   getting to the best-predicting model, given the

1   shortcomings encountered.

2   Now, the best prediction model; that's the

3   whole equation, predicting the left-hand side

4   variable. That, in no way, is going to tell you that

5   the elasticity you're interestea in is correctly

6   estimated. The best prediction could be coming

7   because of the way the time trends are formulated,

8   could be coming because of anything else.

9   So I think, if you have a model that I think

10   is not handled properly, and you get a mean-squared

11   error -- you want to formulate a policy. That policy

12   depends upon an elasticity estimate: If I change

13   this, how will this change?

14   If I go over my sample size and get a model

15   based on a number of shortcomings that predicts as

16   well as possible, I'm just predicting the left-hand

17   side. I don't think that's going to tell me that if I

18   change this variable, the price, because of the

19   coefficient elasticity, that's going to change in a

20   corresponding way. I don't think it tells me that at

21   all.

22   Q   Okay. Let's look at those three formal

23   procedures you identify in the third page of your

24   response to seven, and I'm looking at the second one

25   specifically. Do you see that?

1   A   Yeah. Which one?

2   Q   The one you've labeled as number two, a test

3 involving the nesting of two models.

4   A   Yeah, yeah, yeah.

5   Q   And down towards the bottom of that

6 paragraph, you talk about one of them tests for the

7 joint significance of Z, and my question is, again,

8 isn't the significance of Z going to be something

9 that's reflecting what you've put into the model, and

10 if you haven't put the right things into the model, Z

11 could be significant or not significant, but it

12 doesn't necessarily prove that you have the right

13 model.

14   A   Well, I guess the force of the second one is

15 that there are different formulations to model

16 determination, and one approach that I like is to

17 think of everything you know about the institutions,

18 the data, and all of this other stuff, and formulate a

19 model and then say, "This is my baby. This is it."

20   Now, some people might think there is

21 another model that could be important. If I add the

22 elements of the other model to my model, if my model

23 is correctly specified, then the elements of this

24 other model should count for naught. The elements of

25 the other model here are Z. So this is saying, given

1   my model, I bring in what the other model might add to

2   my model, Z, and if that's not significant, then I

3   have reason to believe I have faith in my model.

4   I also said that if it turns out that Z is

5   significant, there's different approaches people might

6   take. My approach would be to say, "Well, the model

7   that I believed in, I can't believe in anymore because

8   Z is important. I'd better go back to the drawing

9   board."

10   Some people might end up accepting --

11   there's different approaches after that. Mine, and

12   what I stated, I think, is that I would go back to the

13   drawing board. That would be my approach.

14   Q   Changing gears here, you discuss procedures

15   for identifying and correcting autocorrelation in your

16   testimony. Correct?

17   A   No. I don't think I did. I think what I

18   said was -- I could read it again, but I would have

19   handled the autocorrelation problem differently. I

20   think that's what I said. I didn't say, do this, do

21   that, do that. I don't think I said that, anyway.

22   What number was that?

23   Q   I was just looking specifically at pages 12

24   to 14 of your testimony. My question is, and I think

25   you essentially answered it, you address

1   autocorrelation in your testimony.

2   A   Yes, yes, I address it.

3   *Q*   Would you recommend including the lag-

4   dependent variable as an explanatory variable to

5   correct for autocorrelation?

6   **A**   No. That's a specification problem. I

7   think I would specify a model. If my model indicated

8   that the dependent variable should be lagged, then I

9   would lag it, but if I estimate my model, and I have

10   autocorrelation, and I want to get rid of it by

11   putting in a lag-dependent variable, then,

12   effectively, I'm changing the specification of my

13   model. I would not do that.

14   There are ways to test that if I have a

15   model with a lag-dependent variable, and if I want to

16   allow for the possibility that there are

17   autocorrelations, then there are ways to account for

18   this, but they are not as straightforward as they

19   would be in the absence of a lag-dependent variable.

20   MR. KOETTING: Switching gears again, I

21   think, at this point, I would like, with the

22   chairman's permission, to pass out a couple of

23   equations that I previously shared with Mr. Horwood in

24   the expectation that they would. be shared with the

25   witness. If I may approach the witness, Mr. Chairman?

1   CHAIRMAN OMAS: Yes.

2   (Off the record.)

3   CHAIRMAN OMAS: Mr. Koetting, you may

4   proceed.

5   MR. KOETTING: Thank you, Mr. Chairman.

6   BY MR. KOETTING:

7   Q   Professor Kelejian, just to bring us back

8   where we were, I was circulating the sheet of paper

9   that had Equation 1 and Equation 2 on it, which I

10 believe you had some exposure to previously.

11   A   Yes, I do.

12   Q   The demand equation estimated by Witness

13 Tress for the Postal Service for first-class, single-

14 piece letters is estimated using a log-log

15 specification such as shown in Equation 1 that we

16 handed out. Would you agree with that?

17   A   I'm not familiar with -- I only interacted

18 with -- I'm sorry. Repeat the question. I was

19 thinking of something else. Go ahead. I'm sorry.

20   Q   Okay. The equation estimated by Witness

21 Tress on behalf of the Postal Service for, I think,

22 all of his equations, but since we're specifically

23 talking about first class, single piece, he used the

24 log-log specification, as shown in Equation 1 on the

25 sheet we handed out. Correct?

1   A   Yeah. On the part of the testimony, the

2   theoretical presentation that I read, this was the

3   form of the equation, Equation 1. That is true.

4   Q   Let's contemplate an alternative demand

5   specification of the type shown in Equation No. **2** on

6   the sheet that we distributed, and would you agree

7   that that would be, as opposed to a log-log

8   specification, would be something called a "linear

9   specification"?

10   A   Well, the second equation is a linear

11   specification. If the coefficients, A-star and B-star

12   and BP-star are not viewed as having nonlinear

13   restrictions with each other, then that's a linear

14   equation, yes. It's linear in the variables, and to

15   be linear in the coefficients, there should be no

16   nonlinear restrictions relating them.

17   Q   Okay. And if an analyst were looking at

18   these two equations and trying to decide which **of** the

19   two were more appropriate, and the analyst had no

20   reason to believe that the real-world demand curves

21   are linear, without such an a priori reason to prefer

22   the second equation over the first equation, would you

23   agree that the choice between these two equations is

24   something that should be investigated econometrically?

25   A   Well, again, I can only say econometrics is

1   a wide area, a wide field, and what I would do is, you

2   know, more like toss a coin ana pick out the equation.

3   I would pick one of these as being more likely -- it's

4   hard for me to believe that someone would really feel

5   indifferent between the two models.

6   If you pick one model, for argument's sake,

7   Model 1, and then say, "But you know, Model 2 might be

8   it," then there is a J test for that. You could test

9   for this by getting the calculated value of B from

10   Model 2, putting it into Model 1, and see if its

11   coefficient is statistical significant. That's one

12   thing I would do.

13   I might also point out. that there is a

14   difference in modeling between getting a best

15   predictor as compared to -- estimation and prediction

16   are not always in sync with each other. If you wanted

17   to predict V, then, at this point, I can't work out

18   all of the analytics right now, but it's conceivable

19   to me that even if Model 1 were correct, Model 1 would

20   lead to a prediction of log of V, and that's nonlinear

21   in V. So I think, in some cases, Model 2 could

22   predict V better than Model 1, even if Model 1 was a

23   true model, because it's nonlinear.

24   Q   I would, Professor Kelejian, like to go over

25   with you what materials it was that you reviewed in

1   preparing your testimony, specifically, the materials

2   presented by Witness Tress.

3   **A**   In preparing for this testimony, I read my

4   original letter, which has now become testimony, and

5   I'm the kind of guy that I prove something for myself,

6   and then I prove it again and again and again. Oh,

7   no, I made a mistake, and I prove still again. That's

8   one thing I did to get familiar with I wrote.

9   Q   I think we're --

10   **A**   And then I also looked at -- I mean, this is

11   my main preparation. Okay?

12   Q   I'm sorry. I don't mean to interrupt you,

13   but I wasn't really talking about your preparation for

14   this morning. I was talking about, in terms of you

15   have presented what is, as you say, now testimony

16   regarding the presentation put on by Witness Tress.

17   **A**   Yes.

18   Q   And in terms of formulating your reaction to

19   what he did, I'm curious as to which pieces of the

20   body of material that he presented that you had the

21   occasion to look at. For example, he had a piece of

22   direct testimony in this case, and I'm curious if you

23   read the entire testimony or if you read only parts of

24   that testimony.

25   **A**   I read the parts -- I think I stated in my

1   letter, which has since become testimony, that I

2   focused on the procedures as described and not the

3   whole thing. That's what I focused on.

4   Q   And did you have any occasion to look at any

5   of his library references, which may not be a term

6   that you're familiar with, but the background

7   documentation it presents, a body of other materials.

8   Did you --

9   A   Not really. I mean, I think, at one point,

10   some of it -- there must be a lot of it -- was made

11   available to me or described by Reza Sayed. I'm not

12   pronouncing the name properly, but I cannot say I'm

13   familiar with that. I focused on the procedures that

14   he said he used. That's what I did.

15   Q   And did you review his testimony in any

16   previous docket? For example, the last rate case,

17   which was Docket No. R2005-1, did you examine his

18   testimony in that case?

19   A   No. Oh, wait a minute. The only thing I

20   looked at was, originally, what was given to me was,

21   instead of the 206 testimony, the 205 testimony, which

22   was quite similar to the 206 testimony. So I read

23   those parts of the -- is that the question you're

24   asking me now?

25   Q   Yes.

1   **A**   In the beginning, I 30t the **205** -- I'm

2 sorry. I misunderstood the question. In the **205**

3 testimony, I originally went through those parts, the

4 same theoretical parts, describing the procedures, and

5 then when I wrote my letter at that point, Reza

6 actually, in an e-mail, I think it was, sent me and

7 said, You know, you must be reading the **205** testimony

8 because **your** page references are off, and it's really

9 the 206.   Then I looked at the **206,** and

10 I found that the procedures described were virtually

11 the same as they were, I thcught, as in the **205.**

12   **Q**   So what you're saying is the thrust of your

13 testimony was really developed in response to what was

14 presented in **R205** rather than **R206.**

15   **A**   It started that way, hut certainly my letter

16 was revised a number of times, and I think, at this

17 point, it's hard for me to think of how much substance

18 was changed when I went from the **205** to the **206,** but I

19 don't think that much changed. I think it was more

20 that page references were different. The boxed Cox

21 was presented the same way and stuff like that

22   **Q**   Did you have the opportunity to, do you

23 recall, to review any of Witness Tress's responses to

24 interrogatories in this case?

25   **A**   No, I don't think so, no. I don't think I

1   had any of his interrogatories, no.

2   Q   If you don't recall, your answer is

3   sufficient.

4   A   I don't recall reading his interrogatories.

5   MR. KOETTING: I think that's all we have

6   for you, Professor Kelejian.   Thank you very much.

7   Thank you, Mr. Chairman.

8   THE WITNESS: Is anybody else going to --

9   CHAIRMAN OMAS: I'll ask.   Is there anyone

10   else who wishes to cross-examine Witness Kelejian?

11   (No response.)

12   CHAIRMAN OMAS: Are there any questions from

13   the bench?

14   Mr. Horwood, would you like some time with

15   your witness to review whether there is a need for

16   redirect?

17   MR. HORWOOD: Yes.   If we could have five

18   minutes, it would be plenty.

19   CHAIRMAN OMAS: Okay.   Five minutes.

20   (Whereupon, a short recess was taken.)

21   CHAIRMAN OMAS: Mr. Horwood?

22   MR. HORWOOD: Yes.   I just have one very

23   brief matter.

24   REDIRECT EXAMINATION

25   BY MR. HORWOOD:

1   Q   Professor Kelejian, you referred to the **206**

2 testimony and the **205** testimony of Mr. Tress. Was

3 that reference a shorthand for the testimony in Docket

4 R2006 and **R2005?**

5   **A**   Yes, it was.

6   MR. HORWOOD: Thank you. That's all I have.

7   CHAIRMAN OMAS: Is there anyone who wishes

8 to recross? Mr. Koetting?

9   MR. KOETTING: No, thank you, Mr. Chairman.

10   CHAIRMAN OMAS: There being no redirect, Dr

11 Kelejian, that completes your testimony here today.

12 We appreciate your contribution and your testimony,

13 and you're now excused. Thank you very much.

14   THE WITNESS: Thank you, sir.

15   (Witness excused.)

16   CHAIRMAN OMAS: This concludes today's

17 hearings. We will reconvene tomorrow morning at 9:30

18 a.m., when we will receive testimony from Witnesses

19 Mitchell, Prescott, and Smith. Thank you and have a

20 good day.

21   (Whereupon, at 11:07 a.m., the hearing in

22 the above-entitled matter was adjourned, to reconvene

23 at **9:30** a.m. on October **31, 2006.)**

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REPORTER'S CERTIFICATE

DOCKET NO.: R2006-1

CASE TITLE: Postal Rate and Fee Changes

HEARING DATE: 10/30/06

LOCATION: Washington, D.C.

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the Postal Rate Commission

Date: 10/30/06

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